THE UNINTENDED CONSEQUENCES OF TAX TREATIES AND THE UNFAIR ALLOCATION OF TREATY TAXING RIGHTS FROM A DEVELOPING COUNTRY'S PERSPECTIVE

by

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ABSTRACT

THE UNINTENDED CONSEQUENCES OF TAX TREATIES AND THE UNFAIR ALLOCATION OF TREATY TAXING RIGHTS FROM A DEVELOPING COUNTRY'S PERSPECTIVE

Countries often enter into double tax treaties to encourage foreign direct investment by preventing double taxation of income. However, double tax treaties often result in unintended tax consequences such as: redistributing tax revenues from developing to developed countries; facilitating tax avoidance and the resultant base erosion and profit shifting (BEPS) and double non-taxation.

While double tax treaties are entered into with the main objective of eliminating double taxation in order to encourage the said foreign direct investment in developing countries, double tax treaties have not been effective in addressing the unintended consequences of concluding them, impacting the tax revenues of source countries.

In achieving their main objective, double tax treaties contain provisions which can ensure that income is only taxed in one country by allocating taxing rights between residence and source countries that are party to it. However, the allocation of taxing rights in double tax treaties simply redistributes taxing rights from the country where the income is derived (i.e., source country), to the residence country.

The study finds that double tax treaties, mostly those drafted based on the Organisation for Economic Co-operation Development (OECD) Model Tax Convention (MTC), typically favour developed countries as they allocate taxing rights to resident countries.

As a result, the study recommends that developing countries exercise extreme caution when concluding double tax treaties as the unintended consequences of entering into the double treaties result in the loss of much needed tax revenue as the allocation rules contained therein, particularly those that are drafted based on the OECD MTC favour developed countries over developing countries.

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TABLE OF CONTENTS

ABSTRACT I
LIST OF ABBREVIATIONS AND ACRONYMS III
CHAPTER 1: INTRODUCTION 1
1 BACKGROUND 1
1.2 PROBLEM STATEMENT 3
1.2.1 Unintended consequences of tax treaties 3
1.2.2 The unfair allocation of treaty taxing rights 4
1.3 THE PURPOSE OF THE STUDY 4
1.4 SCOPE OF THE STUDY 5
1.5 METHODOLOGY 5
1.6 STRUCTURE OF THE MINI-DISSERTATION 6
Chapter 1: Introduction 6
Chapter 2: Historical background to double tax treaties and the unintended consequences of double tax treaties 6
Chapter 3: The inappropriate allocation of taxing rights in selected Articles of the OECD MTC and the consequences 6
Chapter 4: Recommendations and conclusion 7
CHAPTER 2: HISTORICAL BACKGROUND TO DOUBLE TAX TREATIES AND UNINTENDED CONSEQUENCES OF DOUBLE TAX TREATIES 8
2.1 BACKGROUND TO DOUBLE TAX TREATIES 8
2.1.1 The League of Nations' Model Tax Convention 9
2.1.2 The OECD Model Tax Convention 10
2.1.3 The UN Model Tax Convention 11
2.2 UNINTENDED CONSEQUENCES OF DOUBLE TAX TREATIES 13
2.2.1 Redistributing tax revenue from developing to developed countries 13
2.2.2 Facilitation of tax avoidance and the resultant BEPS 16
2.2.3 Double non-taxation 21
CHAPTER 3: THE INAPPROPRIATE ALLOCATION OF TAXING RIGHTS IN SPECIFIC ARTICLES OF THE OECD MTC 25
3.1 ALLOCATION OF TAXING RIGHTS IN DOUBLE TAX TREATIES 25
3.2 ARTICLE 7 – BUSINESS PROFITS 26

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3.3 ARTICLE 10 – DIVIDENDS 32
3.4 ARTICLE 11 – INTEREST 35
3.5 ARTICLE 12 - ROYALTIES 37
3.6 ARTICLE 21 – OTHER INCOME 39
3.7 OVERVIEW OF OECD'S BEPS PROPOSALS TO REDRESS ALLOCATION OF TAXING RIGHTS 40
3.8 SOME MEASURES THAT DEVELOPING COUNTRIES CAN PUT IN PLACE TO PRESERVE THEIR TAX BASES 41
CHAPTER 4: RECOMMENDATIONS AND CONCLUSION 44
LIST OF REFERENCES 45

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LIST OF ABBREVIATIONS AND ACRONYMS

Table 1: Abbreviations and acronyms used in this document

Abbreviation	Meaning
BEPS	Base Erosion and Profit Shifting
OECD MTC	Organisation for Economic Co-operation Development Model Tax Convention on Income and Capital
MNE	Multinational enterprise
UN	United Nations
UN Model Convention	United Nations Model Double Taxation Convention between Developed and Developing Countries
UAE	United Arab Emirates
USA	United States of America

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CHAPTER 1: INTRODUCTION

1 BACKGROUND

Most countries impose income tax on their residents' global income and the non-residents are taxed based on income received in that country (Daurer & Krever, 2014:1). However, where a person who is a resident of one country receives income from another country (i.e., source country), the two countries may want to levy tax on the same income (Daurer & Krever, 2014:1). This is mainly because the resident country imposes income tax on its residents on worldwide income and the country from which the income was derived would also seek to tax that same income as it was derived from factors attributable to that country (Daurer & Krever, 2014:1). In the absence of a double taxation agreement between the two countries, the above anomaly can emanate in double taxation of the same income which may discourage taxpayers from investing outside of their resident country (Daurer & Krever, 2014:1).

In order to encourage international trade and investment, countries around the world enter into double tax treaties with one another, which contain provisions that can prevent double taxation by limiting the taxing rights of the countries that are party to the treaty (Oguttu, 2018:314). Where the signatories of a double tax treaty are both capital exporting countries (usually developed countries) which have the same flow of income from trade, the impact of the limitations imposed by the double tax treaty on a signatory's right to tax have very little impact on the country's tax revenue (Daurer & Krever, 2014:1). However, if one of the signatories to the double tax treaty is a capital importing country (usually a developing country), the limitations imposed by the double tax treaty tend to shift taxing rights as well as the associated tax revenue, from that country to the developed country (Daurer & Krever, 2014:1). This is particularly the case where the double tax treaty was negotiated based on the Organisation for Economic Co-operation Development Model Tax Convention on Income and on Capital (OECD MTC). This is because the OECD MTC was drafted to favour developed countries, so when developing countries use the MTC to conclude tax treaties with developed countries, they tend to struggle to preserve their source country taxing rights (Oguttu, 2018:314).

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From early in the twentieth century when international tax principles were established, developing and developed countries have been unable to ensure that taxing rights are equally allocated to both groups of countries due to each country's interest to protect their tax base (Oguttu, 2018:315). This is essentially attributable to the fact that developed and developing countries have different interests in protecting their tax bases (Oguttu, 2018:315).

Even though the taxing rights in double tax treaties based on the OECD MTC favour towards developed countries, developing countries continue to conclude double tax treaties with developed countries in an attempt to attract foreign investment capital (Barthel, Busse, Krever & Neumayer, 2010:3). However, should double tax treaties be attributable to an increase in foreign direct investment generated by developing countries, the short-term revenue costs as a result of entering into double tax treaties would, over the longer term, be outweighed by the economic benefits of foreign direct investments generated by the double tax treaty (Barthel *et al.*, 2010:3).

Studies that have been conducted over the years to determine whether double tax treaties have an effect on foreign direct investments, show that the results remain contradictory and inconclusive (Hearson, 2016:3; Petkova, Stasio & Zagler, 2019:2). As such, developing countries end up sacrificing a portion of their tax revenue as a result of entering into double tax treaties with no certainty as to whether there will be any foreign direct investment flowing into their country. One may argue that a few double tax treaties concluded by developing countries are done so with little consideration of their content and impact on government revenue, as these are concluded for political reasons (Hearson, 2017:4).

From the time when the League of Nations drafted its "Report on Double Taxation", the development of international tax and allocation of taxing rights has been in favour of developed countries (Oguttu, 2018:315). Concerns surrounding how taxing rights are allocated in the OECD MTC, triggered a response by the United Nations (UN) which drafted the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model Convention), a model that is designed to be more favourable towards developing countries (Brooks & Krever, 2015:164). This model was first published in 1980 as a result of deliberations of the Ad Hoc Group of Experts on Tax Treaties between developed and developing countries which was created by the Secretary-General of the UN

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in 1968 (UN, 2018:7). The vital contrast between the two model conventions is that the UN Model Convention offers developing countries more taxing rights than the OECD MTC (Hearson, 2017:2). Even though the UN Model Convention was drafted in order to assist developing countries when concluding double tax treaties with developed countries, the UN Model Convention draws heavily from the OECD MTC (Arnold, 2013:4).

1.2 PROBLEM STATEMENT

1.2.1 Unintended consequences of tax treaties

While many developing countries conclude double tax treaties in order to enable international trade and investment with developed countries, double tax treaties trigger the rerouting of investment and income flows. Double tax treaties potentially increase incentives for profit shifting rather than increasing foreign direct investments from developed countries to developing countries (Barthel *et al.*, 2010:3). As a result, double tax treaties contribute to the loss of tax revenue by developing countries and to some extent facilitate tax avoidance (Barthel *et al.*, 2010:2).

Though double taxation is the primary reason that double tax treaties were developed, they have not been effective in addressing issues such as double non-taxation because of the gaps between domestic and international tax laws, leaving some income generated offshore not being taxed or subject only to excessively low taxes (Van de Vijver, 2015:240).

From the above, it is clear that in preventing double taxation, double tax treaties also result in several unforeseen effects that impact on the tax revenues of source countries. The unintended tax consequences that are discussed in detail in Chapter 2 of this work include:

- redistributing tax revenues from developing to developed countries by allocating taxing rights to developed countries, redistributing much needed tax revenue from developing to developed countries;
- facilitating tax avoidance and the resultant BEPS as taxpayers exploit tax rules to prevent profits derived in source countries from being taxed there or shifting those profits to an offshore location; and
- double non-taxation as a result of differences between the tax systems of the signatories that are a party to a double tax treaty.

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1.2.2 The unfair allocation of treaty taxing rights

In addition to the above unintended consequences of double tax treaties, it is also worth noting that while the primary objective of double tax treaties is to prevent double taxation, it is only a few provisions in double tax treaties that achieve this objective (Arnold, 2013:10). In the process of achieving this primary objective, double tax treaties emanate in redistributing tax revenues from developing countries to developed countries (Dagan, 1999:939). This is because double tax treaties have tax redistribution rules which are not in favour of developing countries. This is particularly so with regard to the taxation of business profits, passive income and other income (as discussed in chapter 3).

1.3 THE PURPOSE OF THE STUDY

The purpose of the study is to review relevant literature to determine whether it is necessary for developing countries to continue to conclude double tax treaties by relying heavily on the OECD MTC. This study is undertaken so as to understand the reasons behind developing countries continuing to sign double tax treaties that do not consider their interests.

In doing so, the study first considers the unintended consequences of entering into double tax treaties and how they impact on developing countries. The study proceeds by also considering some of the vulnerabilities of the treaty allocation rules in the OECD MTC in relation to five types of income, namely business profits, dividends, interest, royalties and other income. In this regard, the study looks at how residence based (developed) countries benefit from the treaty allocation rules of the aforementioned types of income by limiting the taxing rights of source based (developing) countries even though the income is derived from resources located in the developing countries.

The study concludes by looking at the measures that have been put in place by the OECDs BEPS Project to address the above-mentioned challenges and whether these measures have been effective in addressing these challenges.

Lastly, the study provides recommendations on how developing countries can approach signing new double tax treaties with countries that seeks to utilise the OECD MTC as a basis for negotiation.

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1.4 SCOPE OF THE STUDY

Due to its limited nature, the study does not cover the new proposed international tax rules under Pillar 1 and Pillar 2 by the OECD Inclusive Framework.

The study does not focus on a single country, rather it focuses on a wider group of countries labelled as developing countries, particularly those in Africa.

This study does not deal with all the Articles in the OECD MTC that deal with the allocation of taxing rights. The study only covers five Articles relating to the taxation of business profits, passive income and "other income" to exemplify how the allocation of taxing rights in those Articles does not benefit developing countries. The study specifically focuses on those five Articles as the UN Model Convention provides for better allocation of taxing rights in respect of the same five Articles (as discussed in Chapter 3). The Articles analysed in this study are:

- Article 7 - Business Profits;
- Article 10 - Dividends;
- Article 11 - Interest;
- Article 12 – Royalties; and
- Article 21 - Other Income.

Furthermore, the study does not quantify the amount of revenue lost by developing countries as a result of the allocation rules contained in most double tax treaties. Likewise, the study does not attempt to answer whether or not an increase in double tax treaties signed by developing countries corresponds with an increase in foreign direct investment, received by the developing countries.

1.5 METHODOLOGY

The current study is a policy research study which aims to understand why developing countries continue to sign double tax treaties which do not consider their interests. Thus, the qualitative research method is adopted in this study. According to Kothari (2004:5), qualitative research is research that is concerned with the study of attitudes, opinions and behaviour, which is relevant to this study.

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The method used in this study is primarily descriptive. Descriptive research is described as research where a distinct case is examined either to see if it gives rise to any general theories, or to see if existing general theories are borne out by the distinct case (Goddard & Melville, 2004:8).

The current study entails a literature review of textbooks, the OECD MTC, the UN Model Convention, reports, printed articles and electronic journals on the topic. A literature review compares the findings from qualitative studies (Grant & Booth, 2009:99). This method compares themes or constructs across individual qualitative studies (Grant & Booth, 2009:99). It is for that reason that this method was adopted to analyse the literature used in this study.

1.6 STRUCTURE OF THE MINI-DISSERTATION

Chapter 1: Introduction

This chapter gives the background of the research topic, clarifies the rationale and purpose of this study and explains the main research objectives and supporting research questions. Chapter 1 presents an overview of the structure of the study.

Chapter 2: Historical background to double tax treaties and the unintended consequences of double tax treaties

This chapter gives a detailed background to double tax treaties, from when the first draft of the first model convention was developed and how they are still followed today. This chapter further provides an explanation of the unintended consequences of double tax treaties which essentially result in the loss of tax revenue for developing countries.

Chapter 3: The inappropriate allocation of taxing rights in selected Articles of the OECD MTC and the consequences

This chapter explains how treaty taxing rights are inappropriately allocated by considering selected Articles that deal with the allocation of taxing rights, namely for business profits,

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passive income and “other income” in the OECD MTC. Furthermore, this chapter explains the consequences of how the unfair allocation of taxing rights; for example, emanates in base erosion of the tax base of source countries as income derived from source countries is shifted to residence countries. Chapter 3 further looks at measures that have been put in place to address the challenges faced by developing countries as a result of treaty base erosion. In particular, it evaluates whether the measures recommended under the OECDs BEPS Project sufficiently addresses the challenges faced by developing countries in relation to treaty taxing rights.

Chapter 4: Recommendations and conclusion

This chapter concludes the study by summarising the findings and making recommendations on how developing countries should proceed when concluding double tax treaties with developed countries particularly where the double tax treaty is negotiated based on the OECD MTC.

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CHAPTER 2: HISTORICAL BACKGROUND TO DOUBLE TAX TREATIES AND UNINTENDED CONSEQUENCES OF DOUBLE TAX TREATIES

This chapter provides a historical background to allocation rules in double tax treaties as well as the challenges associated with entering into double tax treaties that are faced by developing countries.

2.1 BACKGROUND TO DOUBLE TAX TREATIES

Double tax treaties are agreements between two countries, which are, commonly referred to as contracting states, that deal with how the income of residents of two contracting states, earned from their transactions in these states, should be taxed (Hearson, 2017:2). Double tax treaties' objective has always been evidenced by their title or preamble which has historically read as "…the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains". [1] This objective was revised in the preamble of 2017 OECD MTC which *inter alia* states;

> "(State A) and (State B), Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States), Have agreed as follows …"(OECD, 2017:13).

Since double taxation can hinder international trade, many countries often implement unilateral measures in their domestic tax laws that either exempt foreign sourced income from tax or in other instances provides the taxpayer with a credit against domestic tax payable by that resident in the residence country for taxes paid in the other country (Brooks & Krever, 2015:168; Oguttu, 2018:316). However, where two countries have concluded a

[1] For example, in the Convention between the Government of the Republic of South Africa and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes income and on capital gains. Government Gazette No. 24335, 31 January 2003.

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double tax treaty, double taxation can be prevented by allocating taxing rights between the signatories of the tax treaty depending on the model used to negotiate the tax treaty (Oguttu, 2018:317).

2.1.1 The League of Nations' Model Tax Convention

The League of Nations (which was formed after the end of World War 1, 1914-1918) begun the first work on developing a convention to be used to prevent double taxation by drafting the first model convention in 1928 (Kragen, 1964:307; Oguttu, 2018:319). This initial model tax convention underwent two further re-drafts commonly referred to as the Mexico draft (1943) and London draft (1946) (OECD, 2017:6).

The Mexico draft was mainly drafted by South American countries at the Fiscal Committee meetings held in Mexico City between 1940 and 1943 (Brooks & Krever, 2015:162; Oguttu, 2018:319). This draft largely allocates primary taxing rights to source countries (Brooks & Krever, 2015:162; Oguttu, 2018:319). For instance, the Mexico draft provided that business profits generated in a source country were taxable in that country unless the activities associated with those profits were isolated and occasional and there was no permanent establishment created in the source country by that enterprise (Oguttu, 2018:319). Furthermore, the Mexico draft allowed source countries to tax passive income, for instance where royalties were derived in respect of the right of use of intellectual property, source countries could tax those royalties where that right was exploited therein (Oguttu, 2018:320).

After the Mexico draft, the London draft was issued in 1946 which changed the focus of the Mexico draft in that it favoured residence based countries (Brooks & Krever, 2015:163; Oguttu, 2018:320). One of the main differences between the two drafts was that the London draft required that a permanent establishment be created in source countries by an enterprise before the business profits of that enterprise could be taxed in the source country (Oguttu, 2018:320). Over and above that, the London draft also restricted source countries taxing rights in respect of passive income (Oguttu, 2018:320). Unlike the Mexico draft, the London draft reserved taxing rights for residence countries in respect of royalties, completely disregarding source countries (Oguttu, 2018:320).

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However, none of the above-mentioned draft model conventions were ever fully and unanimously accepted as they presented considerable dissimilarities and certain gaps in respect of several essential questions (OECD, 2017:6). Nevertheless, the principles of these two draft Model Conventions were followed with certain modifications in many double tax treaties that were concluded or revised at the time (Kragen, 1964:307; OECD, 2017:6).

2.1.2 The OECD Model Tax Convention

In 1948 work that had been done by the League of Nations in developing the model tax convention was taken over by the Council of the Organisation for European Economic Co-operation as the League of Nations was dissolved in 1945 (Oguttu, 2018:320). In 1961 the Council of the Organisation for European Economic Co-operation became the OECD, which took over the work on developing the model tax convention (Kragen, 1964:308; OECD; Oguttu, 2018:320). Since the OECD comprises of European countries, it is therefore not surprising that to further its developments on the model tax convention, it favoured its member countries (Oguttu, 2018:320). The OECD then embarked on the harmonisation of the principles that were developed in the Mexico and London drafts to develop harmonised principles, definitions, rules and common interpretation in order to ensure that double taxation does not occur (OECD, 2017:7).

From the years 1958 to 1961, four reports were prepared by the Fiscal Committee of the OECD before submitting the final report, which was a combination of all four reports (Kragen, 1964:309; OECD, 2017:7).

In 1963, the OECD issued the first draft convention titled “Organisation for Economic Co-operation and Development Fiscal Committee, Report, Draft Double Taxation Convention 7 (1963)” and at the time called upon member countries to conform to the draft convention when drawing up or amending bilateral conventions between the member countries (OECD, 2017:7). At the time when the draft convention was issued, the Fiscal Committee envisaged that at a later stage the draft convention would have to be revised (OECD, 2017:7). It was envisaged that the revision of the draft convention would have to take into account the fact that member countries would have gained experience in negotiation and practical application of the convention (OECD, 2017:7).

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The first draft convention has had to be revised over the years to take into consideration new technologies that were being developed, the manner in which taxpayers were undertaking their cross-border transactions and the fact that the tax avoidance and tax evasion methods employed by taxpayers were becoming more sophisticated (OECD, 2017:7). The model convention has since been updated 11 times in; 1992, 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and 2017 (OECD, 2017:7; Oguttu, 2018:320).

As the model convention also impacted on non-OECD member countries, the revision process of the convention was opened up to non-OECD member countries and other international organisations as it was believed that contributions from other parties would assist the Fiscal Committee with enhancing the rules and principles of international tax (OECD, 2017:7). These updates were not full updates to the model convention but rather periodic updates that were meant to accurately reflect the member countries' views at that particular point in time (OECD, 2017:7). Over time, the positions of a number of non-OECD member countries' were included in a second volume to recognise the growing impact of the model convention on non-OECD member countries (OECD, 2017:7).

It is clear from the above that even though the OECD MTC revision process was opened up to non-OECD member countries, the OECD MTC is predominantly meant to be relied on by OECD member countries which in many instances are capital exporting countries (OECD, 2017:7). It therefore, gives favourable taxing rights to capital exporting countries (as is discussed in Chapter 3) with respect to the taxation of business profits in Article 7, passive income contained in Articles 10, 11 and 12 as well as any other income in Article 21 not addressed by any specific Article of the MTC, regardless of where that income arises from (OECD, 2017:20; Oguttu, 2018:320-321).

2.1.3 The UN Model Tax Convention

Recognising the importance of encouraging investment in developing countries, the UN adopted a resolution that allows the setup of experts and tax administrators to explore methods for the negotiation of double tax treaties between developed and developing countries (Lennard, 2008:23). These methods needed to ensure that both groups of countries fully preserve their respective revenue interests and are acceptable to both groups of countries (Lennard, 2008:23). In accordance with that resolution the, UN "Manual for the

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Negotiation of Bilateral Tax Treaties between Developed and Developing Countries" was produced in 1979 to serve as a guideline to be used as a base for the negotiation of double tax treaties between capital exporting and capital importing countries (Lennard, 2008:24). This manual led to the UN publishing the UN "Model Double Taxation Convention between Developed and Developing Countries" in 1980 (UN, 2018:7).

Although the UN Model Convention is principally based on the OECD MTC, it provides a bargain among the two principles of source and residence though it gives greater support to the principles of source than the OECD MTC (UN, 2018:8). It therefore, gives favourable taxing rights to capital importing countries, particular with respect to the Articles selected for this study (as is discussed in Chapter 3), which are the taxation of business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12) and any other income (Article 21).

The UN Model Convention aims to provide a balanced approach in its Articles as it recognises that:

- taxing income earned from a foreign source should also take into account the expenses incurred in deriving that income;
- tax imposed on non-residents should not be so high that it discourages investment; and
- tax imposed on non-residents should also consider the principle of apportioning some tax revenue to the resident country (UN, 2018:9).

The UN Model Convention is intended to equip authorities tasked with the responsibility of negotiating double tax treaties on behalf of their countries, with information needed to recognise beforehand the costs of the different approaches which may be relevant to their country's specific situation (UN, 2018:8).

Though the UN Model Convention is meant to assist developing countries with preserving their taxing rights when negotiating double tax treaties with developed countries, the effort to advocate for developing countries has over the years been hindered by under-funding and a lack of strong support from developed countries (Oguttu, 2018:315).

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Like the OECD MTC, the UN Model Convention has also been revised over the years to take into account the changes that have taken place globally (UN, 2018:7). More specifically, the UN Model Convention was revised in 2001 and 2014 (UN, 2018:7). The revision, as well as the update of the UN Model Convention and the accompanying manual was to reflect international tax cooperation issues as a result of the increasingly frequent update to the OECD MTC (UN, 2018:7).

Following from the above, the section below highlights in detail, the costs associated with entering into double tax treaties which developing countries need to consider when entering into double tax treaty negotiations.

2.2 UNINTENDED CONSEQUENCES OF DOUBLE TAX TREATIES

Much of the global economy (global investment regime and world trade) is administered by bilateral treaties, however, there are unintended consequences and adverse externalities (discussed below) that emerge as a result of conducting the global economy through decentralised networks of bilateral treaties (Arel-Bundock, 2017:1). In an international tax context, although double tax treaties have been used to eliminate double taxation, they have unintended consequences (Arel-Bundock, 2017:1).

2.2.1 Redistributing tax revenue from developing to developed countries

Double tax treaties relieve double taxation by shifting taxing rights from the one country (normally the source country) to the other country (normally the resident country) (Avi-Yonah, 2007:2; Barthel *et al.*, 2010:4). The issue with this is that where there is no double tax treaty between the two countries, the source country in which the income is derived would have exclusive taxing rights to the income, meaning that, the resident country would only be left with residual or no taxing rights to that income (Avi-Yonah, 2007:3; Barthel *et al.*, 2010:4). However, where the two countries have a double tax treaty in place, taxing rights of the source country are capped to a certain rate or removed entirely based on the nature of the income (Barthel *et al.*, 2010:4).

While the primary objective of double tax treaties is to prevent double taxation, they play a relatively minor role in this regard (Barthel *et al.*, 2010:4; Brooks & Krever, 2015:165). The

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bulk of the measures in double tax treaties do not fit clearly into accomplishing the primary objective of tax treaties (Brooks & Krever, 2015:166). The measures intended to prevent double taxation, inadvertently allocate taxing rights by primarily shifting taxing rights from source countries (largely developing countries) to residence countries (largely developed countries) (Barthel *et al.*, 2010:4). In essence, double tax treaties allocate taxing rights to residence countries which supply foreign investment by capping the taxing rights of the source country or removing them entirely (Barthel *et al.*, 2010:4).

This is achieved by setting maximum tax rates that the source country may impose on passive income, such as interest, dividends and royalties and entirely remove the source country's right to tax business profits of a non-resident unless a permanent establishment has been created by a taxpayer that is not a resident of that country (Barthel *et al.*, 2010:4). Further discussion on the limitation of treaty taxing rights for these types of income is in Chapter 3 of this study.

Notwithstanding their purpose, double tax treaties are remarkably ineffective at addressing the most important causes of double taxation such as the inconsistent characterisation of income and the inconsistent source rules (Brooks & Krever, 2015:168). For instance, if two countries attribute different characters and consequently different sources to the same income flow, neither country's rules for preventing double taxation are triggered as neither recognises the income as having a source in the other country (Brooks & Krever, 2015:168).

In order to avoid double taxation, double tax treaties make each country that is a party to it relinquish something (Dagan, 1999:944). In this instance the residence country provides its residents a credit in respect of foreign taxes paid to the source country provided that the source country either reduces its taxes or grants a reciprocal credit (Dagan, 1999:944). As a result, the residence and source countries' losses of tax revenue are the cost of receiving increased levels of cross-border investment (Dagan, 1999:944-945). Therefore, the reallocation of taxing rights from source countries to residence countries ensures that income is only taxed once, provided that the residence country provides the taxpayer with a credit for the tax paid to the source country (Brooks & Krever, 2015:166).

At first glance, it seems reasonable that each country forgoes something in order to avoid double taxation. This is based on the presumption that double taxation is invertible in the

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absence of a double taxation treaty (Dagan, 1999:945). However, even with double tax treaties in place, countries also have unilateral measures that prevent double taxation and these are used with the cooperation of other countries (Avi-Yonah, 2007:2; Dagan, 1999:945). One can argue that without double tax treaties, countries will still be able to prevent double taxation and they would be able to do it without redistributing tax revenue from one country to another (Dagan, 1999:945).

It can be argued that double taxation may be avoided by resident countries unilaterally by way of exempting cross-border income or providing a credit for the taxes paid cross-border against the tax payable in the resident country (Brooks & Krever, 2015:162). The unilateral approach offers a resident country a range of policies that can be adopted to reduce the double taxation suffered by its own residents regardless of the source country's policy and independent of any bilateral treaty provisions (Dagan, 1999:942).

It is against this background that there are no advantages to ceding tax jurisdiction through double tax treaties as opposed to unilaterally in domestic legislation (Brooks & Krever, 2015:161). To the extent that sacrificing taxing rights might actually yield additional benefits, the beneficial outcomes would be maximised if the source country acted unilaterally rather than selectively, trading off taxing rights for perceived non-tax advantages by means of double tax treaties (Brooks & Krever, 2015:175). From the above, it is clear that in practice, most double tax treaty provisions deal with the allocation of taxing rights, not the prevention of double taxation. For most taxpayers the allocation rules are unlikely to have a dramatic impact on their overall tax burden (Arnold, 2013:10; Barthel *et al.*, 2010:6).

Therefore, the countries that stand to benefit from the conclusion of double tax treaties are resident countries, as they stand to gain taxing power and tax revenue from income that was generated outside of their borders (Barthel *et al.*, 2010:5). Double tax treaties do not increase taxing rights or tax revenue of source countries but rather increase taxing rights and tax revenue of resident countries (Brooks & Krever, 2015:163).

Consequently, the question remains; in preventing double taxation, are double tax treaties still needed when unilateral measures can do so in an efficient and stable manner (Dagan, 1999:940). If not, then double tax treaties simply serve to primarily redistribute tax revenue from developing countries to developed countries (Dagan, 1999:940). As such double tax

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treaties today do no more than reaffirm the use of the credit or exemption methods that most countries have unilaterally adopted to prevent double taxation (Barthel *et al.*, 2010:6; Dagan, 1999:941).

2.2.2 Facilitation of tax avoidance and the resultant BEPS

According to the OECD, the term "tax avoidance" refers to the arrangement of a taxpayers affairs in a manner that is aimed to reduce his tax liability (OECD). Payne and Raiborn (2018:470) define tax avoidance as the act of using legal means to reduce tax liability based on a number of provisions in tax law. This is done by exploiting loopholes in tax laws and using them within legal parameters so as to reduce the said tax liability (Fuest & Riedel, 2009:5; Oguttu, 2016:518). While tax avoidance is legal, it does however, go against the purpose of the law (OECD). Adding to this, it is important that tax avoidance is distinguished from tax evasion which is illegal (Fuest & Riedel, 2009:5). Even though tax avoidance is legal, the use of this practice has over the years been questioned by tax authorities as the resultant tax loss is associated with governments' ability to achieve their economic and social objects (Oguttu, 2016:519).

The concept of tax avoidance is as mentioned above distinguished from "tax evasion", which refers to the act of dishonestly reducing or concealing taxable income items or increasing allowable deductions so as to reduce tax liability so that taxpayers pay less tax than they are obligated to (Payne & Raiborn, 2018:470). Over the years, multinational companies have been blamed for being in what is termed as "aggressive tax avoidance" which refers to tax avoidance schemes which go beyond legally exploiting loopholes in tax law, but use suspect legal interpretation or an obscure paragraph in tax provisions to legally exploit the loopholes in tax rules eroding the tax base of many countries (Payne & Raiborn, 2018:470).

Recognising the impact of base erosion on tax receipts, tax jurisdiction and tax integrity on its members, the OECD undertook to work on this matter (OECD, 2013b:7). The OECDs commitment to work on this matter resulted in it releasing a report on the BEPS Project titled "Addressing Base Erosion and Profit Shifting" (OECD, 2015a:5).

The OECDs BEPS Project addresses BEPS practices which erode the tax base of countries by shifting profits to low tax jurisdictions. It is worth noting that BEPS is enabled by the fact

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that the current international tax system and domestic tax have not evolved with the changing business environment (OECD, 2013b:5). Even though more businesses are operating across borders at an increasing rate, tax laws remain uncoordinated and taxpayers are restructuring their businesses in a manner that is technically legal but takes advantage of the gaps in domestic and international tax laws (Oguttu, 2016:524).

To counter BEPS, the OECD issued a 15-point Action Plan (Burgers & Mosquera, 2017:29; OECD, 2015a:4; Oguttu, 2018:326). This package lays down three tiers of norms in the form of "minimum standards"[2], "international guidelines"[3] and "best practices"[4] to be operationalised in both OECD and non-OECD countries through multiple soft and hard law mechanisms (Christians, 2016:1604-1605; OECD, 2015a:6).

The BEPS measures address the improper use of double tax treaties to benefit persons that the treaty is not intended to benefit as this poses a risk to tax revenues of the contracting states (Baker, 2013:3; Oguttu, 2016:517). This is the case when taxpayers get involved in treaty shopping schemes as discussed below.

A country's treaty network can be manipulated by residents of a non-treaty country (through treaty shopping schemes) in order to obtain treaty benefits that are not supposed to be accessible to them (Oguttu, 2007:237). While the term treaty shopping has not been officially defined, this refers to the practice whereby multinational enterprises (MNEs), rather than investing directly in a source country, redirect the investment through a third country to make use of treaty provisions not found between the country where the investment originates from and the source country (Chaisse, 2015:228; Oguttu, 2007:238; van 't Riet & Lejour, 2018:1322). Treaty shopping is one of the practices that MNEs use to exploit the differences in the national tax codes of different jurisdictions (van 't Riet & Lejour, 2018:1323).This is often the case when the repercussions of withholding taxes are too high and MNEs shop for a country with a favourable treaty network and interpose a conduit company in that country (Arel-Bundock, 2017:8). In using double tax treaties to prevent double taxation countries

[2] A set of standards agreed on in order to avoid negative spill overs that would be created where no action is taken by some countries (OECD, 2015a:6).

[3] Guidelines reflecting common understanding and interpretation of international tax principles (OECD, 2015a:7).

[4] Best measures in place to curb BEPS (OECD,2015a:6).

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have unintentionally created treaty shopping opportunities for MNEs (Arel-Bundock, 2017:2; Oguttu, 2007:238).

While most countries in the world levy withholding taxes on passive income such as interest, dividends and royalties paid to non-residents, if these taxes are too high this can result in MNEs involved in cross-border investments losing part of their revenue to taxes (Oguttu, 2007:241). When two countries sign a double tax treaty, the burden of withholding taxes on taxpayers can be reduced which creates a clear path for MNEs to channel funds through a cheap indirect route by establishing conduits in strategic locations (Arel-Bundock, 2017:11).

When a country's withholding taxes are reduced by a double tax treaty, this exposes it to treaty shopping opportunities from residents of other countries. This implies that even if the benefits granted by a double tax treaty are purely reciprocal, the effects of the double tax treaty may not remain restricted to the signatory parties (Arel-Bundock, 2017:11). The principle of reciprocity, which is fundamental to all double tax treaties, is hampered when residents of a third country benefit from a treaty that is only intended to benefit residents of the countries that are a party to it (Oguttu, 2007:241). As such, many countries condemn the practice of treaty shopping as it undermines the underlying principle of reciprocity (Weyzig, 2013:912). Treaty shopping is unwanted because double tax treaties are entered into with the assumption that income will accrue to both signatories and as such the awaited income is distorted where the double tax treaty is used by residents of a third country (Oguttu, 2007:241).

Because many countries do not maintain treaty relationships with their treaty partners this behaviour encourages conduit treaty shopping as investors tend to use other countries' treaty networks to obtain treaty benefits in a country which the investor wants to invest in (Oguttu, 2007:240).

In recent years, efforts have been made by the OECD to address the practice of treaty shopping (Oguttu, 2007:242). These efforts resulted in certain provisions being included in existing double tax treaties such as the:

- "subject to tax" provision which states that the host country can only grant treaty benefits to a taxpayer if the income earned by the taxpayer is subject to tax in the host country;

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- "channel approach" deals with the inappropriate use of double tax treaties by employing conduits;
- "limitation of benefits" provision which aims to prevent third country residents from accessing benefits of a double tax treaty meant for the benefit of residents of the contracting states; and
- "beneficial ownership" clause in respect of passive income, which denies treaty benefits being granted unless the income is received by a person beneficially entitled to it and such person is a resident of one of the signatories of the double tax treaty (Oguttu, 2007:242-243).

The OECDs 2015 BEPS Action Plan 6 titled "Preventing the Granting of Treaty Benefits in inappropriate Circumstances" (Action Plan 6) recommends that treaty shopping can be prevented by using the following three approaches (OECD, 2015c:22):

- Firstly, when entering into double tax treaties, contracting states should include a statement stating that they want to prevent tax avoidance and prevent setting up opportunities for treaty shopping. This statement should explicitly be stated in the preamble of the double tax treaty and should explicitly refer to treaty shopping as an example of tax avoidance that should not result from tax treaties (OECD, 2015c:93). Action Plan 6 further states that the title of the relevant treaty also clearly states that the objective of the tax treaty is to prevent tax evasion and avoidance (OECD, 2015c:93).
- Secondly, it was recommended that the OECD MTC includes a 'limitation on benefit' provision. This provision is an anti-avoidance provision specifically aimed at addressing treaty shopping (OECD, 2015c:22). This provision seeks to deny the granting of treaty benefits to persons that are not entitled to those benefits where such persons establish structures that indirectly benefit from treaty benefits not meant to be accessible to them while recognising that in some instances such structures may be established for legitimate business purposes (OECD, 2015c:25); and
- Lastly, it was recommended that a general anti-avoidance provision based on the "principal purpose test" is included in the OECD MTC for arrangements that would not be covered by the "limitation on benefits" provision discussed above. The "principal purpose test" seeks to deny the granting of treaty benefits where one of the principal purposes of a transaction or arrangement is to obtain a tax benefit under a tax treaty

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whilst obtaining that benefit would be in contrary with the objective and purpose of the OECD MTC (OECD, 2015c:57).

While countries have a choice as to how to draft these anti-avoidance provisions into their double tax treaties, Action Plan 6 recommends countries that wish to only adopt the "principal purpose test" provision refer to the detailed version of the "limitation on benefits" and further supplement it with a mechanism that allows it to address other specific conduit arrangements (OECD, 2015c:23). However, a country which prefers to only adopt the "principal purpose test" provision may also rely on the simplified version of the "limitation on benefits provision" as that will provide it with the flexibility of a general anti-avoidance rule which provides it with the ability to prevent a larger number of abusive transactions (OECD, 2015c:24).

A combination of the abovementioned anti-avoidance provisions acknowledges that both provisions have strengths and weaknesses (OECD, 2015c:21). As mentioned above the "limitation on benefits" provision provides that treaty benefits shall not be granted to persons that are not entitled to them. As such, as an objective criteria is used for the "limitation on benefits" provision, it provides more certainty than the "principal purpose test" provision (OECD, 2015c:21). As a result, the "limitation on benefits" provision is more useful as a specific anti-avoidance provision that can be used to reduce the number of treaty shopping schemes that are easily identifiable (OECD, 2015c:21). However, the "limitation on benefits" provision only focuses on curtailing treaty shopping and as a result other arrangements that also result in treaty shopping such as conduit financing arrangements are not addressed (OECD, 2015c:21). Furthermore, as the "limitation on benefits" provision specifically addresses treaty shopping schemes it therefore, does not address other forms of treaty abuse (OECD, 2015c:21).

The "principle purpose test" stipulates that treaty benefits shall not be accorded to a taxpayer where one of the principal purposes of a transaction is to attain a benefit under a tax treaty. While the "principal purpose test" is a general anti-avoidance provision, it requires that each transaction is evaluated against its own facts and circumstances in order to determine whether one of the key purposes of an agreement results in a tax benefit in a way that is in contravention with the objective and purpose of the double tax treaty (OECD, 2015c:21).

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As Action Plan 6 is a minimum standard of the OECD BEPS Project this implies that new tax treaties signed by countries must include the abovementioned provisions (OECD, 2015c:22) To the extent that countries' existing treaties do not already contain the abovementioned recommendations, countries will need to renegotiate their existing tax treaties in order to incorporate the abovementioned recommendations of Action Plan 6 (OECD, 2015c:22). Given the time it takes to renegotiate tax treaties countries may incorporate these recommendations in their existing treaties by signing the Multilateral Instrument as these recommendations are included in Article 7 of the Multilateral Instrument (OECD, 2015c:22). The Multilateral Instrument is a multilateral convention that is currently used as a mechanism to implement treaty related BEPS measures that were formulated as a result of the BEPS Project (OECD, 2015a:9). However, participation in the Multilateral Instrument is optional (OECD, 2015c:22). Furthermore, even though signatories of a double tax treaty are signatories of the Multilateral Instrument, both countries may have different views on how these provisions should be applied (OECD, 2015c:22). Thereby, making the implementation of the recommendations of Action Plan 6 challenging and leaving countries that are signatories to treaties that do not contain such provision still prone to treaty abuse.

2.2.3 Double non-taxation

Double non-taxation refers to an instance where the interaction between current international tax rules developed to mitigate double taxation and uncoordinated domestic tax systems leave certain income untaxed (Marchgraber, 2014:1). The fundamental principle of international taxation is that income is only taxed once. This means that international tax norms should not only avoid double taxation, but they should prevent income from not being taxed at all by making sure that income is taxed at least once (Ting, 2014:41). However, for a long period of time the focus of double tax treaties has been on ensuring that taxpayers are not subject to tax more than once rather than making sure that double non-taxation does not occur (Ault, 2013:1195). One may argue that one of the reasons for this is that some countries are happy to see structures that reduce the tax burden on their MNEs activities abroad and facilitate double non-taxation to enhance their tax competitiveness (Ault, 2013:1195).

While double taxation is deemed to be unfair on taxpayers, double non-taxation has more far-reaching consequences for governments as it affects tax revenues, distorts competition,

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causes economic efficiency and hinders on transparency and fairness (Broe, 2014:310). Though an extensive treaty network may help eliminate double taxation and encourage collaboration between tax authorities, an extensive treaty network may also open up benefits to harmful preferential tax regimes[5] in some countries if the treaties themselves do not contain self-protection measures such as; specific anti-avoidance provisions as well as effective mechanisms for exchange of information between tax authorities (OECD, 1998:33).

More often than not, double non-taxation arises when exclusive taxing rights are provided to a specific country and that country does not exercise its taxing right by not imposing tax (Marchgraber, 2014:2). For instance, this could be the case where a country has been allocated exclusive taxing rights in terms of a treaty, but in terms of their domestic law that income is exempt or that country does not levy any taxes on that type of income. An example of this can be found in a double tax treaty between Mozambique and the United Arab Emirates (UAE)[6] where any passive income that is earned by a UAE resident from Mozambique is only taxable in the UAE however, the UAE only operates a territorial tax system, as a result any such passive income earned in Mozambique by its resident is not taxable in the UAE leaving the income completely untaxed in both countries (IBFD, 2020).

Double non-taxation may also arise due to the different definitions of "resident" for persons other than natural persons, where one contracting state only considers a company to be resident if it is incorporated and the other contracting state only considers the company to be resident where its central management and control is based (Ting, 2014:46). An example of this lies in the double tax treaty between the United States of America (USA) and Ireland[7]. In this instance, the USA considers a company to be resident if it is incorporated in the USA, whereas Ireland considers a company to be resident where its central management and control is located. Thus, where an MNE that is incorporated in Ireland has its central management and control in the USA, the company is effectively not resident in the USA nor in Ireland, leaving the company to only be taxed on income received from a source in Ireland

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[5] These are regimes that generally provide a favourable location for holding passive investments. These regimes are in many cases designed to act as conduit for routing capital flows across borders (OECD, 1998:25).

[6] Agreement between the Government of the United Arab Emirates and the Government of the Republic of Mozambique for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital.

[7] Convention between the Government of Ireland and Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains.

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which may be significantly less if the company's income comprises of income from the letting of intangible assets outside of Ireland (Ting, 2014:47).

It must be noted that even if a double tax treaty is aligned with domestic tax laws of both countries that are a party to it, it is possible that due to disparities in evaluating the facts of the case or both countries interpret the double tax treaty differently, some income may remain untaxed (Marchgraber, 2014:2). Furthermore, when unintended beneficiaries of double tax treaties have a choice to choose the location of their businesses they end up using double tax treaties designed to prevent double taxation to eliminate taxation altogether, resulting in the income not being taxed at all (Oguttu, 2007:241).

Though efforts have been made by the OECD to address the issue of double non-taxation created by double tax treaties, double non-taxation which results from the inconsistencies in domestic tax laws and international standards remains a vulnerable issue (Marchgraber, 2014:3). MNEs often take advantage of the double non-taxation gaps in treaties for their tax planning, which is traditionally treated as a legitimate practice around the world unless unclear borders to abusive behaviour are crossed (Marchgraber, 2014:1).

Tax authorities are concerned about the tax loss which arises from tax planning that takes advantage of the double-non taxation (Marchgraber, 2014:1). Furthermore, double non-taxation is one of the causes of BEPS, which the OECD sought to address in the BEPS Project. The OECD notes that BEPS also arises in:

> "… instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. No, or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words what creates tax policy concern is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed" (OECD, 2013a:12).

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As a result, Action Plan 6 of the 2015 BEPS Project gives clear clarification that double tax treaties are not meant to be used to facilitate double non-taxation. As such, Action Plan 6 of the BEPS measures recommends that the preamble of the OECD MTC is replaced to refer *inter alia* to the fact that the contracting states intend "… to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduce taxation through tax evasion or avoidance …" in order to address issues of double non-taxation (OECD, 2015c:92).

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CHAPTER 3: THE INAPPROPRIATE ALLOCATION OF TAXING RIGHTS IN SPECIFIC ARTICLES OF THE OECD MTC

The previous chapter provided a historical background to double tax treaties as well as the unintended consequences faced by developing countries as a consequence of entering into double tax treaties that were negotiated using the OECD MTC. This chapter looks at the inappropriate allocation of taxing rights in the OECD MTC by focusing on specific Articles of the MTC.

3.1 ALLOCATION OF TAXING RIGHTS IN DOUBLE TAX TREATIES

In order for a country to ensure that an individual is subject to their tax laws, there must be a connection between the income earned by that individual and the country that wishes to impose the tax (Arnold & McIntyre, 2002:15). As different countries use different tax systems, double taxation can occur where a resident of a country that has adopted the worldwide tax system invests in a country that uses the source tax system to tax income that is derived from that country. This results in what is commonly referred to as juridical double taxation, in that, a single taxpayer is accountable for tax on the same amount in the same year in two different countries (Arnold & McIntyre, 2002:27; Pickering, 2013:6).

Where juridical double taxation occurs and a tax treaty is in place between the two countries in which a person operates, the treaty can by allocating taxing rights, eliminate double taxation (Olivier & Honiball, 2011:269) . Such allocation of taxing rights largely depends on the nature of the income. In some instances, the residence country is provided with an exclusive right to tax, in that case the resident country is the only country that is allowed to tax that income, irrespective of where the source of that income is located (Oguttu, 2018:317). In other instances, neither country is allocated exclusive taxing rights, but one country is allocated primary taxing rights and the other country is allocated secondary taxing rights (Oguttu, 2018:317).

Tax treaty allocation rules limit the amount of taxes levied on an amount but do not in themselves impose the tax (Oguttu, 2018:317; Olivier & Honiball, 2011:273). In double tax treaties, the extent of the allocation and limitations of taxing rights for some income types, depends on whether the OECD MTC or UN Model Convention was used to negotiate the

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double tax treaty (Olivier & Honiball, 2011:279). According to Oguttu (2018:317), as the OECD MTC symbolises rules and proposals of developed countries over developing countries, the allocation of taxing rights in this model requires source countries to relinquish some or all of their taxing rights on certain types of income, effectively reducing their tax revenue.

The discussion below highlights the treaty allocation rules for business profits, passive income and other income.

3.2 ARTICLE 7 – BUSINESS PROFITS

Article 7(1) of treaties based on OECD MTC provides that profits derived by a resident of a contracting state in another contracting state must only be taxable in the first mentioned contracting state unless a permanent establishment has been created by a person that is not a resident in the source country (OECD, 2017:16). This effectively means that unless the source country can prove that a permanent establishment has been created by that resident through its activities carried therein, the profits associated with those activities may not be taxed by the source country.

When it comes to business profits derived by taxpayers in a source country, double tax treaties have historically defined the scope of tax in a more limited way than would otherwise be permitted under domestic law (Brooks & Krever, 2015:169; Daurer & Krever, 2014:8; Hearson, 2016:9). The business profits Article of the OECD MTC entirely removes the taxing rights of the source countries over the business profits derived thereof, unless a permanent establishment has been created and those profits can be associated with that permanent establishment (Brooks & Krever, 2015:169; Daurer & Krever, 2014:8; Hearson, 2016:9). The concept of a permanent establishment as referred to in the OECD MTC, means "… a fixed place of business through which the business of an enterprise is wholly or partly carried on" (OECD, 2017:15). This essentially means that some level of commercial activity must be undertaken by the taxpayer in the source country before the source country can levy tax on the profits generated therein (Hearson, 2016:9).

In essence, this permanent establishment threshold requires a substantial economic presence to be established in the source country by a person that is not resident in that

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country before such profits can be subject to tax (Brooks & Krever, 2015:169; Castro, 2011:130; Oguttu, 2009:773). Even if a permanent establishment does exist in terms of Article 7(1), it is only those profits that are attributed to that permanent establishment which the source country is allowed to tax (Brooks & Krever, 2015:169; Castro, 2011:130; Oguttu, 2009:773). Therefore, since the non-residents' full business profits cannot be taxed in the source country, this requires a determination of the amount that should be taxed as it arises from activities of the permanent establishment (Oguttu, 2009:776). The OECD MTC and the UN Model Convention both make reference to a permanent establishment. Testing the requirements of a permanent establishment against the facts and circumstances of each case makes it extremely complex and difficult for taxpayers and tax authorities to determine when a permanent establishment has been created by a taxpayer (Castro, 2011:129). This makes managing permanent establishment risk by taxpayers an important part of tax planning so as to reduce the taxpayers overall tax burden in the source country (Hearson, 2015:21).

The criteria to determine whether or not a permanent establishment has been created by a taxpayer in a source country is based on each taxpayer's circumstances. This among other things includes whether or not the taxpayer operates through a fixed place of business through which the business of the enterprise of the taxpayer is carried on in the source country, whether the taxpayer carried out construction, building or installation projects in the source country that lasted for more than 12 months or whether the taxpayer has a dependent agent in the source country carrying on the enterprise of the taxpayer therefore, creating a permanent establishment for the taxpayer (OECD, 2017:15). As such, the responsibility lies with the source country to prove that the activities of a non-resident constitute a permanent establishment situated therein. Even though Article 7(2) of the OECD MTC provides a list of examples of what might constitute a permanent establishment in terms of the general definition of Article 7(1), in order to constitute a permanent establishment there must be some level of permanency (OECD, 2017:57). Therefore, where a person that is not a resident is physically present in a source country this will not lead to the creation of a permanent establishment by the non-resident in that country (OECD, 2017:57). Consequently, it is for this reason that activities such as delivery warehouses may not be considered as meeting the definition of a permanent establishment, effectively excluding income associated with such activity from taxation in the source country (Hearson, 2016:9). Article 5(4) of the OECD MTC contains exclusions to the permanent establishment

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definition, which further limit source countries' right to tax based on this threshold. Prior to the 2017 update of the OECD MTC the exclusions were:

a) "the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock or merchandise belonging to the enterprise solely for the purpose of display or delivery;
c) the maintenance of stock or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity that of a preparatory or auxiliary character; or
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character." (OECD, 2014:17).

The above exclusions applied automatically where the excluded activity met the specifications of a fixed place of business in Article 5(1), essentially meaning that tax cannot be levied by the source country on the income that is associated with that activity as that activity is not considered to meet the definition of a permanent establishment (OECD, 2015b:28).

Although Article 5(4) has been updated to restrict all of the abovementioned activities to those of a preparatory or auxiliary nature, providing source countries with a broader scope of activities which may constitute permanent establishments (OECD, 2017:15). This places more burden on source countries to prove that the excluded activities are not preparatory or auxiliary in nature. This added responsibility on source countries comes as a result of the fact that it cannot easily be determined when activities carried out by an enterprise are preparatory or auxiliary in nature (OECD, 2015b:28; OECD, 2017:61). While a non-essential activity that is carried out prior to carrying out an activity that is essential and significant for an enterprise as a whole is considered to be preparatory in nature, an activity is considered to be auxiliary in nature if it is carried out to support an enterprise as a whole (OECD, 2017:62).

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Having regard to the meaning ascribed to activities of a preparatory or auxiliary nature, new anti-fragmentation provision was also introduced to protect source countries against taxpayers that may divide their operations into smaller operations to be able to rely on the provisions of Article 5(4)(f) by arguing that each small operation is of a preparatory or auxiliary nature (OECD, 2017:65). The ramification of the new anti-fragmentation rule is to deny reliance on the provisions of Article 5(4) where activities are carried out by a non-resident at a particular location and other activities of that same resident are carried out at another location within the same country constitute integral functions that are part of a cohesive business operation of that non-resident (OECD, 2015b:39; OECD, 2017:65). However, these provisions only apply where at least one of the locations where those activities take place constitutes a permanent establishment leaving source countries with the same problem that they have always faced, proving that a permanent establishment has been created by the non-resident (OECD, 2017:65). Even though these provisions can also be applied where the overall activity of the non-resident, resulting from all activities carried out by that person in the source country are preparatory or auxiliary in nature, the combination of such activities must be more than preparatory or auxiliary in nature (OECD, 2017:65). For developing countries with limited administration capacity this results in increased administrative work to prove that the combination of all activities undertaken by the non-resident in the developing country go beyond what is characterised as preparatory or auxiliary.

Therefore, when determining whether activities that the non-resident undertakes in the source country are not preparatory or auxiliary in nature, source countries need to determine which of those activities do not constitute complementary functions of the business of the non-resident in view of the business of the non-resident as a whole (OECD, 2017:61).

The abovementioned rules on business profits sound harsh at first from a source country's perspective, however, in reality tracking all business transactions entered into by taxpayers is challenging and the more limited the capacity of the tax administration of a country is, the more difficult the task (Daurer & Krever, 2014:8). Furthermore, there may be limited capacity to actually collect tax on business income received by foreign business with no permanent bases in the country that enter the country only to carry out profit making transactions (Daurer & Krever, 2014:8-9).

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While the UN Model Convention's Article 7 is similar to the one contained in the OECD MTC, it also grants taxing rights to source countries where the non-resident derives business profits from the selling of goods or merchandise that is similar to those sold by a permanent establishment in the source country (UN, 2018:38). In essence, once a permanent establishment has been created in the source country, the source country is provided with more taxing rights over other business profits derived in the source country from any other activities undertaken therein by that same non-resident even if those activities are not activities of a permanent establishment of that non-resident, a principle commonly referred to as a "limited force of attraction" (UN, 2018:236).

This principle has been rejected in the OECD MTC as the way modern business is carried out is highly complex and there are many companies that are engaged in a wide diversity of activities (OECD, 2017:82). The OECD MTC further rejects this principle on the basis that if this principle is applied to the wide diversity of activities, it could seriously interfere with the ordinary commercial activities of those companies in a manner that is contrary to the objective of the OECD MTC to promote the exchange of goods and services and movement of capital, technology and persons by removing the obstacle of double taxation (OECD, 2017:82). Although this principle may result in some uncertainty for taxpayers, it does however, assist developing countries with some administrative problems that come with having to determine whether an activity that the non-resident carries out is connected to that non-resident's permanent establishment, or whether the income derived by the non-resident is associated with a permanent establishment of that non-resident (UN, 2018:238). It was against this background that it was decided that the "limited force of attraction" principle should be retained in the UN Model Convention.

Furthermore, even though the UN Model Convention's Article 7 requires the creation of a permanent establishment by a non-resident before business profits derived by the non-resident can be taxed in that country, the UN Model Convention's definition of a permanent establishment is far broader than that of the OECD MTC. For example, where a non-resident has a building site, construction site or an installation project in the source country, the OECD MTC requires that the said site exists for more than 12 months in order to be considered a permanent establishment (OECD, 2017:15). Whereas, the UN Model

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Convention requires that such a site only exists for more than 6 months in order for that activity to be considered a permanent establishment (UN, 2018:33).

Not only does the UN Model Convention provide developing countries with a lower time limit compared to the OECD MTC, it also provides a wider list of activities that are covered under Article 5(3)(a) such as assembly projects and supervisory activities. The UN Model Convention further provides source countries with more taxing rights in subparagraph (b) of Article 5(3) where services including consultancy services are being provided in the source country through an employee of a non-resident for more than 183 days in any 12-month period, a provision that is not included in the OECD MTC (UN, 2018:33). The UN Model Convention contains this provision so as to avoid a developing country's tax base from being eroded by non-residents through the rendering of services to their affiliates located in source countries as enterprises of industrialised countries generate large profits from such activities (UN, 2018:178). It is further considered that where services are being rendered by a non-resident for more than 183 days, the involvement of the non-resident in the financial life of that country needs to be reflected and as such justifies that country taxing the income from those services (UN, 2018:183).

Moreover, Article 5(5)(b) of the UN Model Convention provides developing countries with greater taxing rights where a non-resident has a dependant agent in the source country. In this instance, a permanent establishment will also be deemed to have been created where stock that is habitually maintained by a dependant agent is regularly delivered by the dependant agent on behalf of the non-resident, a situation which is not provided for in the OECD MTC (UN, 2018:35). This provides source countries with an opportunity to tax profits generated by the non-resident from the sale of goods where such a sale was done through a dependant agent and all other activities related to that sale, such as advertising or promotion are undertaken in the source country whether by the non-resident them self or the dependant agents in that country (UN, 2018:217).

Over and above all the advantages provided by the definition of a permanent establishment in the UN Model Convention, Article 5(6) specifically deals with certain aspects of insurance businesses, aspects which the OECD only addresses in its commentary. In this instance, insurance businesses are deemed to have a permanent establishment in the source country if it collects insurance premiums in the source country or insures risks situated therein

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through a person other than an independent agent (UN, 2018:35). This provides source countries with taxing rights over profits that would not in ordinary circumstances be taxed in the source country due to the nature of the business carried out by insurance companies (UN, 2018:218).

Even though Article 7 of both model conventions are similar, if not the same, it is clear from the above that it is the definition of a permanent establishment contained in the OECD MTC that restricts the taxing rights of source countries, making the OECD MTCs Article 7 more restrictive than that of the UN Model Convention.

3.3 ARTICLE 10 – DIVIDENDS

In double tax treaties, the allocation rules for taxing dividends are contained in Article 10 of treaties based on both the OECD and the UN Model Tax Conventions. Dividends as referred to in Article 10 are defined in Article 10(3) as:

> "… income from shares, *jouissance* shares or *jouissance* rights, mining rights, founders' shares or other rights, not being debt-claims, participating in profits as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is resident" (OECD, 2017:17).

Therefore, where shares of a company that is resident in one country are held by a resident of another country, the repatriation of funds through dividends from that company by its non-resident shareholder may result in the erosion of that country's tax base. As a result, many countries levy withholding taxes on dividends made by its residents companies to non-residents allowing the source country to generate tax revenue from those payments (Hearson, 2015:17). Withholding such taxes plays an anti-avoidance role as it discourages MNEs from repatriating excessive profits to their resident countries through these payments (Hearson, 2015:17).

Withholding taxes on dividends in particular, may influence MNEs behaviour to reinvest the profits they make rather than repatriating them or moving the said profits offshore (Hearson, 2015:17). However, the withholding tax rate which source countries can levy on dividends

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is limited to 5% in terms of Article 10(2) of the OECD MTC, to the extent that the beneficial owner of the dividends directly holds throughout a 365 day period 25% of the shares of the company paying the dividend, resulting in a lower withholding tax rate than what would normally apply with no tax treaty in place (Brooks & Krever, 2015:173; Hearson, 2015:17; Hearson, 2016:9). However, where the above-mentioned requirements (i.e., 25% shareholding throughout a 365 day period) are not met, the withholding tax rate is reduced to 15% of the gross amount of such a dividend (OECD, 2017:17).

The OECD MTC or the commentary thereto, does not define the word "beneficial owner". Therefore, in accordance with the provisions of sub-paragraph 2 of Article 3, any term that is not defined therein, shall have the meaning that it has under the domestic laws of the countries that seek to apply the tax treaty (OECD, 2017:14). However, without a clear definition under the domestic laws of the two signatories of the double tax treaty this could result in the term being interpreted in a demeanor that is contrary with the objective and purpose of the OECD MTC which includes to avoid double taxation and prevent fiscal evasion and avoidance (OECD, 2017:110).

In terms of the commentary the word "beneficial owner" is meant to be interpreted in the context of the words "paid… a resident" and it is not meant to be interpreted in a narrow technical manner (OECD, 2017:110). This essentially means that the term should not be understood and used in a limited technical sense but should rather be used in context of the words "paid… to a resident" having regard to the fact that the object and purpose of the OECD MTC is to avoid and prevent double taxation and fiscal evasion (OECD, 2017:110). This makes it bare that the source country does not have to give up its taxing rights over dividend income simply because it is paid to a resident of another country (OECD, 2017:110). However, were dividends are paid to a person that is acting in his or her capacity as an agent or nominee, such a person cannot be said to be the beneficial owner of the dividend simply because they received that dividend (OECD, 2017:110). Moreover, such a person cannot be said to be the beneficial owner of the income because the said person does not have a right to use and enjoy that dividend, but rather has on obligation to pay over that dividend to its rightful owner (OECD, 2017:110). These principles equally apply to cases where such a person is a conduit company acting as a fiduciary or administrator (OECD, 2017:110). While the commentary provides the context in which the term needs to be interpreted in, one also needs to look at the meaning ascribed to the term in international

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court cases. In the case of *Prevost Car Inc. v Her Majesty, The Queen*, 2008 TCC 231 it was held that "… the beneficial owner of income is the person that who receives the income for his or her own use and enjoyment and assumes the risk and control of the income he or she receives". This principle was also upheld in the case of *Velcro Canada Inc. v Her Majesty, The Queen,* 2012 TCC 57. Therefore, over and above the reduced withholding tax revenue from the dividend paid to the non-resident, source countries need to establish whether the person receiving the dividend is indeed the beneficial owner of the dividend.

The only reasonable argument for reducing withholding tax is that the investor would have already contributed to an increase in direct foreign investment in the source country but this argument has, to date, not been proven to yield such results (Brooks & Krever, 2015:173). As dividend withholding tax is not a tax on current profits, it can be deferred indefinitely by investors who are willing to reinvest in the source country to generate greater current profits, as such higher withholding tax rates on dividends might encourage more investment than lower rates (Brooks & Krever, 2015:173). Furthermore, research shows that the matrix of factors that affect investment decisions, in particular direct foreign investment, is that tax rates, especially withholding tax rates, play a marginal role at best in tipping a decision to-, or not to invest in a particular country (Brooks & Krever, 2015:174). Factors such as labour costs, infrastructure facilities, labour force skills, political stability, proximity to market, transportation costs, environmental costs and a host of other factors are cited as more important than tax considerations in terms of driving foreign investment locations (Brooks & Krever, 2015:174).

From the above, it can be argued that, there is no reason for source countries to reduce withholding taxes on dividends as foreign investors consider many different factors before investing in a country as tax is a secondary consideration in driving investments (Brooks & Krever, 2015:174).

Most notably, the difference between Article 10(2) of the OECD MTC and the UN Model Convention is that while the OECD MTC outrightly decreases the withholding tax rate to 5% where all requirements (i.e., 25% shareholding throughout a 365 day period) are met and to 15% in other cases, the UN Model Convention leaves these percentages open to be established by the two countries when negotiating the double tax treaty (UN, 2018:281). This allows both the source and the resident country to decide on an appropriate withholding

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tax rate which will not only benefit the resident country but also benefit the taxpayer (UN, 2018:282).

Nevertheless, both model conventions provide that the above-mentioned withholding tax rules shall not apply where the beneficial owner of the dividend has created a permanent establishment in the source country and dividends are received by that beneficial owner in respect of a shareholding that is effectively connected with that permanent establishment (OECD, 2017:17; UN, 2018:42). While this relieves the source country from the limitations contained in Article 10, that dividend must be dealt with under Article 7, providing the source country with unlimited taxing rights over the dividend and yet again having to prove that the activities of the beneficial owner constitutes a permanent establishment situated therein (OECD, 2017:114).

3.4 ARTICLE 11 – INTEREST

The allocation rules for taxing interest are contained in Article 11 of treaties based on both the OECD and the UN Model Conventions. Article 11(3) of the OECD MTC defines interest as:

> "… income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds and debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for purposes of this Article" (OECD, 2017:18).

If a parent company provides loan funding to its subsidiary in another country, to the extent that the loan provided bears interest, the interest on the loan is normally treated as a tax deduction expense of the subsidiary (Oguttu, 2018:333; Olivier & Honiball, 2011:219). As a result, MNEs prefer funding their subsidiaries through loan capital rather than equity as dividends do not qualify for a tax deduction (Oguttu, 2018:333; Olivier & Honiball, 2011:219). To protect their tax bases from excessive interest deductions countries often apply anti-avoidance measures to prevent debt shifting to lower tax jurisdictions through intra-group loans (Oguttu, 2018:333; Olivier & Honiball, 2011:219).

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Even though a source country may have measures to protect its tax base from excessive interest deductions, a double tax treaty can limit its taxing rights (Oguttu, 2018:333). Article 11(1) of the OECD MTC essentially gives primary taxing rights for interest to the residence country of the taxpayer receiving the interest. However, Article 11(2) provides the source country with secondary taxing rights provided that the person receiving the interest is the beneficial owner of the interest and a resident of the other contracting state (OECD, 2017:18). However, even though the source country has secondary taxing rights, it can only tax up to 10% of the interest paid (OECD, 2017:18). Following on from section 3.3 above, the term "beneficial owner" in this context, should also be interpreted in line with the objective and purpose of the OECD MTC. Therefore, in order to be able to levy tax on the interest paid, the source country must firstly prove that the person that received the interest is the beneficial owner of the interest. However, proving beneficial ownership in an international tax context may be very challenging for countries where tax administrations have limited capacity, which is the case in many of the developing countries (Oguttu, 2018:334).

Regardless of whether the source country can prove beneficial ownership, its taxing rights remain limited to 10% of the amount of the interest paid (Arnold & McIntyre, 2002:125; Oguttu, 2018:334; Olivier & Honiball, 2011:233). In practice, the tax rate on interest of most developing countries' double tax treaties is often reduced below 10% (Oguttu, 2018:334). In some instances, the tax on interest is reduced to zero as in the case of the double tax treaty between South Africa and the United Kingdom[8], which provides that any interest earned shall only be taxable by the residence country. Although African countries tend to have high interest withholding tax rates in their domestic laws, in treaty negotiations they are often under pressure to reduce the rates to zero or near zero even though these countries also contribute to the production of the interest income received by the non-resident (Brooks & Krever, 2015:170; Oguttu, 2018:335).

As double tax treaties provide maximum withholding tax rates which source countries can levy, Oguttu (2018:335) recommends that double tax treaties provide lower limits to which

[8] Convention between the Government of the Republic of South Africa and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains. Government Gazette No.24335, 31 January 2003.

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the withholding tax rate should not fall, in order to allow source countries to generate reasonable amounts of tax revenue for its contribution to generating the interest income.

While the interest Article of the OECD MTC limits the source country's taxing rights to 10%, the interest Article of the UN Model Convention leaves the tax rate to be charged on the interest payment to be agreed on by the two countries when negotiating the double tax treaty (UN, 2018:302). Thus, allowing for both the residence and source country to agree on a rate that is favourable for both countries by taking into account the following (UN, 2018:303):

- the country where the capital provided originates from;
- the fact that high withholding taxes might be included as part of the cost of borrowing by lenders (so called 'grossing up'), meaning that the source country would generate large amounts of tax revenue from its residents; and
- the fact that the residence country might not provide a full tax credit for the foreign taxes paid in the source country which might defer investments.

As in Article 10, Article 11(4) of both model conventions provide that the limitation rules contained in paragraph 1 and 2 of Article 11 shall not be applicable where the beneficial owner of the interest has created a permanent establishment in the source country and the interest paid is in respect of a debt-claim that is effectively connected with that permanent establishment, providing the source country with unlimited taxing rights (OECD, 2017:17; UN, 2018:43). Even though the source country has unlimited taxing rights in this respect, the source country firstly needs to prove that a permanent establishment has been created in order to have unlimited taxing rights over the interest paid.

3.5 ARTICLE 12 - ROYALTIES

Article 12 of the double tax treaties based on the OECD and UN Model Tax Conventions provides for allocation rules for taxing royalties. Royalties are defined in Article 12(2) of the OECD MTC as:

> "… payments of any kind received as a consideration for the use of, or the right to us, any copyright of literary, artistic or scientific work including cinematography films, any patent, trademark, design or model, plan, secret formula or process, or

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for information concerning industrial, commercial or scientific experience" (OECD, 2017:18).

Royalty payments are returns to the owner of intangible property[9] for the use or exploitation of that property. As such, following the direct connection between the payments and the use of property, it is an accepted international norm that the source of royalty payments is situated in the country in which the property is used and from which payments are made (Brooks & Krever, 2015:172). Most countries include royalties received by non-residents derived from the use of intellectual property[10] in their gross income and as such royalties received attract normal income tax and a deduction can be claimed by the payer of the royalty for the royalty expense incurred (Oguttu, 2018:337). To prevent base erosion by way of paying royalties, many countries often rely on special anti-avoidance provisions regarding royalties, exchange controls and withholding tax on royalties to limit excessive deductions claimed as well as to limit the exportation of the funds by way of a royalty (Oguttu, 2018:337).

Despite such measures, the OECD MTC limits taxing rights of royalties for source countries through treaty allocation rules. Article 12(1) of the OECD MTC states that royalties originating from source countries and beneficially owned by a resident of another country shall only be taxed in the residence country (OECD, 2017:18). This means that the residence country of the recipient of the royalty has exclusive taxing rights over royalties that are derived in the source country.

Similar to Articles 10(2) and Article 11(2), Article 12(2) of the UN Model Convention does not limit the source country's taxing right to a specific rate but rather leaves the percentage open to be negotiated by the two countries when negotiating the double tax treaty (UN, 2018:44).

As in Articles 10 and 11, both model conventions provide the source country with unlimited taxing rights to the extent that the beneficial owner of the royalty has created a permanent establishment in the source country (OECD, 2017:18; UN, 2018:44). Essentially, over and above proving that the non-resident is beneficially titled to the royalty, the source country

[9] Property with no physical existence but has value that is based on the owner's legal right (OECD).
[10] Work that is protected by copyright, patent or registered design (OECD).

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also has to prove that the non-resident has created a permanent establishment in the source country and that the right or property in respect of which the royalty is paid is effectively connected to that permanent establishment (Oguttu, 2018:338; Olivier & Honiball, 2011:379).

3.6 ARTICLE 21 – OTHER INCOME

In double tax treaties which are negotiated based on the allocation rules of the OECD MTC, any other income arising, that is not dealt with in accordance with the provisions of any specific Article is dealt with in terms of the provisions of Article 21 and shall only be taxable in the residence country (OECD, 2017:20). Article 21 of the OECD MTC completely removes the source country's taxing rights even if the income was derived therein, simply because that income is not addressed by any specific Article of the MTC. Article 21 of the OECD MTC applies irrespective of whether the right to tax is exercised by the residence country, which in some instances may lead to double non-taxation if the residence country does not exercise its taxing right (OECD, 2017:171).

Unlike the OECD MTC, Article 21(3) of the UN Model Convention provides taxing rights to the source country over any other income that is not addressed by the Model Convention where such income is derived therein, a significant divergence from the OECD MTC (UN, 2018:53). Both model conventions provide that the above-mentioned rules shall not apply where the person receiving such income has created a permanent establishment in the other country and the right or property in respect of which such income is paid is effectively connected with the said permanent establishment (OECD, 2017:20; UN, 2018:52).

From the above, it is clear that unless the recipient of other income not dealt with in accordance with the provisions of any other Article of the OECD MTC, the source country has no taxing rights over that income even if it was derived from that country. This is evidence that the OECD MTC favours residence countries over source countries.

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3.7 OVERVIEW OF OECD'S BEPS PROPOSALS TO REDRESS ALLOCATION OF TAXING RIGHTS

The intention of the OECDs BEPS Project was to develop a comprehensive action plan that would coordinate countries' rights to tax with real economic activity (OECD, 2013b:10).

Based on this intention, it was presumed that the OECD would address the question of unfair taxing rights inherent in double tax treaties since it is a fundamental issue that is at the centre of diverging interests of developed and developing countries (Burgers & Mosquera, 2017:31). Critics were therefore of the view that by failing to re-examine the allocation rules in double tax treaties, the OECD appears to have missed the opportunity to evaluate the entire tax system and deal with the root of the problems inherent in the international tax system (Oguttu, 2018:327). It appeared that the BEPS Project was overshadowed by OECD member countries wishing to protect their own national interests rather than addressing international tax issues faced by other countries (Oguttu, 2018:328).

Various authors therefore, recommended that the scope of the BEPS Project be expanded to ensure issues relating to fair allocation of taxing rights that are of concern to developing countries are dealt with (Burgers & Mosquera, 2017:34).

It is therefore encouraging to note that as a result of the challenges that the digital economy poses on the tax systems of many countries, the OECD embarked on a second phase of its BEPS Project, under which it has come up with a proposed "Unified Approach" referred to as Pillar 1 (OECD, 2020:7). Pillar 1 essentially entails new rules that will re-stabilise the international tax system by introducing new nexus rules for international taxation that are not based on physical presence as well as new profits allocation rules (OECD, 2020:8). The new nexus rules will be able to be applied irrespective of the existence of a physical presence by a company, allowing for profits derived by that company to be taxed in the country in which that company actively participates (OECD, 2020:8). This essentially means that a new taxing right will be created for market countries without companies being physically present in that country (OECD, 2020:12). It is anticipated that all remaining work that needs to be done under the banner of Pillar 1 will be completed by the end of 2020 (OECD, 2020:22).

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There are also proposals set out under Pillar 2 which seek to provide countries with a right to "tax back" income they were not initially allowed to tax, where tax was not levied by other countries or where it was levied at very low tax rates (OECD, 2020:27). A discussion of the new proposed international tax rules under the banners of Pillar 1 and Pillar 2 is beyond the scope of this work. It is however hoped that as these new rules are being addressed, the concerns of developing countries as discussed above, will be addressed by the OECD.

3.8 SOME MEASURES THAT DEVELOPING COUNTRIES CAN PUT IN PLACE TO PRESERVE THEIR TAX BASES

Since the introduction of double tax treaties in the 1920s, restrictions imposed by double tax treaties on withholding taxes levied by developing countries have intensified (Hearson, 2016:3).

While not always fully aware of the extent to which double tax treaties would affect future tax policies, treaty negotiators of developing countries continue to enter into double tax treaties that constrain the country's tax policymaking autonomy for the future (Hearson, 2016:7).

Studies show that African countries have not been successful in retaining their taxing rights when negotiating double tax treaties with developed countries which in most cases is attributable to the lack of negotiation capability by African treaty negotiators (Hearson, 2016:10). It has been found that negotiation outcomes often reflect asymmetries of power, knowledge and bargaining skills and that negotiators and policy makers with limited capacity to assimilate information often resort to methods that are not guaranteed to be optimal but nevertheless suffice for reaching an immediate short-term goal (Hearson, 2018:234). This is achieved by placing greater emphasis on information that is more available because it is easier to understand or obtain (Hearson, 2018:234).

The negotiation of double tax treaties requires highly skilled staff as it is a lengthy process which involves interpretation and administration of tax treaties (Pickering, 2013:23). Therefore, in order for developing countries to be in a state to achieve the desired outcome from treaty negotiations, they have to ensure that they have sufficient highly skilled staff who are trained to undertake the abovementioned functions (Pickering, 2013:23). However, this

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is likely to result in the divergence of skilled staff tasked with other priorities from tax administrations of developing countries (Pickering, 2013:23). Furthermore, these tax administrations need additional technical assistance which will assist them in meeting their tax treaty obligations (Pickering, 2013:23). The lack of highly skilled staff in treaty negotiations is detrimental to developing countries that are trying to negotiate double tax treaties that are best suited to achieved their desired outcome (Pickering, 2013:24). Based on the above, the following measures are recommended in order to protect developing countries' tax bases. This may require that developing countries consider the following:

Including Article 26 of the OECD MTC in their tax treaties. Article 26 will assist developing countries with protecting their tax base and minimise tax evasion as the provisions of this Article do not only apply to persons that are residents of countries that are a party to a tax treaty (Baker, 2013:15). Furthermore, the scope of Article 26 is not limited to only the taxes that are covered by a tax treaty, therefore this will provide developing countries with the ability to access information which they would not ordinarily have access to in order to exercise their taxing rights under their domestic law (Baker, 2013:15). However, in terms of Article 26(5), a country cannot decline to provide another country with information because that information is in the possession of another person such as a bank or nominee acting in an agency (OECD, 2017:22). This may prove to be a challenge for tax authorities that already have capacity restraints where the tax authority has to go beyond its own internal administrative processes to retrieve the requested information from the said bank or nominee in order to provide it to its treaty partner (OECD, 2017:233). Having said that, for some developing countries it might not be beneficial for them to include Article 26 in their double tax treaties given the rigorous process of obtaining information that is in the possession of other third parties as developing countries will need additional capacity to be able to exchange information as stated in Article 26 of the OECD MTC, with tax administrations from other countries with which double tax treaties are signed (OECD, 2017:234).

In addition to the above, developing countries may include Article 27 (i.e., Assistance in the collection of taxes) of the OECD MTC in their tax treaties. This will assist developing countries where their residents have assets throughout the world but cannot go beyond their borders to collect the taxes associated with those assets. Even though this mechanism might assist authorities with collecting taxes that are outside of their borders, some country's

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laws may prevent this form of assistance (OECD, 2017:237). Moreover, countries would also have to bear the costs of collecting the taxes from the taxpayer on behalf of the treaty partner where such costs cannot be recovered from the taxpayer itself (OECD, 2017:238).

Having said that, it is worth noting that a number of developing countries in Africa have begun to reassess their approach to double tax treaties by either reviewing, cancelling or renegotiating some of their double tax treaties (Hearson, 2016:7; Hearson, 2018:234). For instance, Rwanda and South Africa have successfully renegotiated tax treaties with Mauritius; Zambia has started renegotiating some old treaties that are most at risk of abuse; and Uganda put a hold on the negotiation of new treaties while formulating a clear policy in respect of double tax treaties (Hearson, 2015:9). Even though measures are being taken by some of the developing countries to reassess their approach towards tax treaties, it is also important for developing countries to understand the impact that the content of the double tax treaty itself has on developing countries as this will allow developing countries an opportunity to determine whether that particular double tax treaty is a good deal or not for the developing country (Hearson, 2016:7).

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CHAPTER 4: RECOMMENDATIONS AND CONCLUSION

This study has highlighted that while treaties are normally entered into to strengthen economic relations with the specific treaty partner, double tax treaties often result in unintended tax consequences such as: redistributing tax revenues from developing to developed countries; facilitation of tax avoidance and the resultant BEPS; and double non-taxation.

The work has also shown that the allocation of taxing rights for business profits, passive income and other income, in double tax treaties based on the OECD MTC, typically favour developed countries as they allocate taxing rights to resident countries by redistributing tax revenue from the source to the resident country.

It is therefore recommended that developing countries exercise extreme caution when entering into double tax treaties with developed countries that are based on the OECD MTC as it is more likely that the double tax treaty will represent the developed country's interests more than those of the developing country. It is further recommended that developing countries consider using a balance of the OECD MTC and the UN Model Convention to draft their tax treaties to ensure that the treaties that they enter into do not solely represent the interests of their counterparts. Developing countries should be careful not to give up their taxing rights in double tax treaties and they should always ensure that their interests are reflected in the tax treaties that they enter into.

Furthermore, it is recommended that as the OECD works on the new international tax rules (under Pillar 1) which could change the nexus rules and the profit allocation rules, that there be equal allocation of taxing rights between developed and developing countries instead of simply representing the interests of its member countries.

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