BILATERAL TAX TREATIES
A MECHANISM TO PROMOTE DEVELOPMENT

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Abstract: This article analyzes bilateral tax treaties and their influence on investment flow to developing countries. It is based on the premise that foreign direct investment promotes development by creating employment, infrastructure, technological advances and workforce qualification. Bilateral Tax Treaties, therefore, can have a beneficial impact on attracting investments by coordinating tax regimes and stipulating how to tax multinationals, consequently turning into a mechanism to promote development. In order to confirm such hypotheses and maximize investment flows to developing countries, this article will analyze two models conventions used by countries while signing a Bilateral Tax Treaty, the OECD Model and the United Nations Model Convention, aiming to understand its flaws and possible suggestions towards its efficiency regarding development. The alternatives found at the end of this study, point out two possibilities: accurate tax sparing provisions and treaty finance, a concept brought by Mitchell Kane.

Keywords: bilateral tax treaties, investment, development.
1. Introduction

This article is about tax treaties and the possibility to turn them into a mechanism that promotes development. This approach is based on the premise that foreign direct investment ("FDI") on developing countries can have an impact towards promoting better living conditions for its population. It is possible by spillover effects experienced by local citizen, especially by the creation of jobs and opportunities, the promotion of markets competitiveness, know-how, technology, infrastructure, among others¹.

Considering the factors that an investor takes into consideration while deciding where to invest, the after-tax rate of return in foreign countries might vary and, therefore, be a key issue to make such decision. Local frailties such as lack of infrastructure and absence of specialized work force can be outweighed in tax favorable regimes towards FDI². In other words, investors’ tax costs, if minimized in comparison to other jurisdictions, can compensate costs experienced throughout the operation of the business abroad and consequently motivate foreigners to invest in a developing country³.

Multinationals gave rise to an issue regarding taxation as they are spread out in multiple jurisdictions. As a result, Bilateral Tax Treaties⁴ ("BTT") are being used since the last century to coordinate tax policies between treaty partners. In order to do so, these conventions are designed to harmonize tax definitions and jurisdictions, in an attempt to well define how global taxation works and limits double taxation incidences⁵.

To address double taxation, most tax treaties, based on the OECD model treaty guidelines, specify that both signing countries must either exempt foreign-earned profits from domestic taxation or offer foreign tax credits when calculating the domestic tax bill. In addition to the provisions for double taxation relief, treaties usually reduce maximum allowable

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³ Ibid.

⁴ In this article, Bilateral Tax Treaties and Double Taxation Conventions will be used as synonyms. The reason why I prefer to call it a BTT is because this article aims to extend the reasons behind an agreement (initially to avoid double taxation) to further on contemplate the promotion of development in a broader spectrum.

withholding taxes on three types of remitted income: dividend payments, interest payments and royalty payments. As such, these treaties end up adjusting tax environment for foreign investment and their incentives while choosing where to invest\(^6\).

There are two models of BTT that aim to promote a harmonized tax treaty framework. The OECD Model as mentioned above and the United Nations Model Double Taxation Convention (“UN Model”) between developed and developing countries, which has as an objective the promotion of development. States when signing BTT has observed both model conventions. Because of this, we shall assume for this article’s scope that those are the models adopted by the majority of countries and therefore analyze their implications.

After several years in which the treaties were in full force, scholars were able to gain sufficient data and prove that the way BTT are drafted today do not promote FDI in developing countries and, even, sometimes, ended up decreasing the amount that existed before\(^7\). The motive behind those facts is that since treaties can reduce tax avoidance and other tax-saving strategies by coordinating tax policies between treaty partners, they might actually have a dampening effect on FDI conducted with that sole purpose\(^8\).

Overall, current BTT establishes clearer rules of how to tax subsidiaries, repatriation, foreign branches and promote exchange of information between governments. As such, the tax incentives to invest in a developing country ended up not outweighing other costs experienced in developing States. It is fair to assume that those treaties are intended to reduce administration costs, reduce tax evasion and to extract concessions from treaty partners\(^9\).

There is also the concern that tax treaties were concluded in accordance to lobbying efforts by profit-seeking investors\(^10\). If this is the case, then treaties may be geared towards maximizing investor profits rather than promoting efficient investment\(^11\). Moreover, by aiming

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\(^6\) Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2\(^{nd}\) edition.

\(^7\) Ibid.

\(^8\) Ibid.

\(^9\) Ibid.


to eliminate treaty shopping and transfer pricing, treaties may reduce the incentive to engage in investment for tax minimization reasons, leading to decreased FDI activity.

Due to the above, it is possible to say that the way tax treaties are drafted today do not aim to promote development in significant ways. Therefore, the question raised and addressed by this article is whether a tax regime can be used as a mechanism to promote effective development.

There are a few hypotheses that might contribute to this discussion. Tax sparing treaty provisions could be better aligned with tax incentives given by developing countries and be narrowly drafted to predict numerous situations in which tax sparing occurs. As a result, tax benefits granted by developing countries would still be preserved\(^\text{12}\).

Another solution was proposed by NYU’s professor Mitchell Kane\(^\text{13}\). It involves the idea of finance through tax treaty. This alternative contemplates a two-step process, in which the first one consists of a capital transfer from the developed country to the developing country to invest in the promotion of FDI and other matters to promote development. In order to recoup the capital transfer, the developed country would be entitled by the treaty’s provision to collect taxes.

Both ideas will be further elaborated as a mean to present alternatives to the way BTTs are signed.

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2. The relation between FDI and development

Development is commonly associated with economic growth that can also be understood under the broader concept of human development. As defined by the United Nations Development Programme, human development concerns the richness of human life as whole, and not only richness of the economy in which those human beings live. As such, it is focused on improving the lives of people lead not just associated with economic growth, because income growth is a means to development.\(^\text{14}\)


Through the human development approach, people will ultimately have the opportunity to be free and chose for themselves the life they want to live, in an environment that allows them to develop their full potential and to have the chance of leading productive and creative live\(^\text{15}\). This means that promoting human development should focus on education, health care, employment, democracy, ending poverty, inequality, access to technology, etc.\(^\text{16}\)

In the United Nations ("UN") Conference on Trade and Development from 1996, it was expressed the important role of FDI in promoting development, noticed as it follows:

> Foreign direct investment (FDI) can play a key role in the economic growth and development process. The importance of FDI for development has dramatically increased in recent years. FDI is now considered to be an instrument through which economies are being integrated at the level of production into the globalizing world economy by bringing a package of assets, including capital, technology, managerial capacities and skills, and access to foreign markets. It also stimulates technological capacity building for production, innovation and entrepreneurship within the larger domestic economy through catalyzing backward and forward linkages\(^\text{17}\).

The language brought in the conference is quite general, but still outlines a couple of core reasons why FDI promotes development, as the transfer of technology and including market. This might end up promoting local companies’ well-being and competitiveness, consequently growing and creating jobs.

It is important to notice that both ways FDI occurs can have an impact on the populations living conditions. First, by ownership control experienced in mergers and acquisitions of local companies, and second through what is called greenfield investment. It consists in contributions made directly to capital formation and improving local productive capacity by building a new venture in a given foreign country with new facilities from scratch. In those cases, a part of the production line is established in another country\(^\text{18}\). This is why greenfield investments can be

\(^{15}\) Ibid.


even more important to a developing country as it associated with the production of new facilities, like offices, building, plants, factories, having positive, permanent and direct impact on employment and capital formation.\textsuperscript{19}

What will determine how much a country will progress due to FDI depends its capacity to absorb spillover effects of the presence of foreign companies through increased supply of technology, products, employment opportunities and infrastructure\textsuperscript{20}. This is why it is important for an investment to be effective and not only to promote profit for investors. The profit occurred needs to be aligned with the best practice for such countries’ development, otherwise the linkages between local economy and global market can be a downstream and harm the State more than develop it\textsuperscript{21}.

Not only does FDI not replace domestic investment but it may even cause it to increase. Local capital markets, are often not well developed and cannot meet the capital requirements for large investment projects. Additionally, potential local investors may lack access to the hard currency needed to acquire investment goods. FDI solves both of these problems. However, by helping to develop local capital market and by creating export opportunities, FDI may also result in a increase in the amount of local capital available for investment\textsuperscript{22}.

This excerpt emphasizes repercussion of FDI that can also express in more detail by the following benefits: (1) increased revenue to the host country and government, via taxes and also indirectly, by the increase of tax revenue on wages and consumer spending; (2) increased employment, by the greenfield investments above mentioned; (3) introduction of new skills and technology, which will then lead to higher productivity and competitiveness; (4) spillover effects\textsuperscript{23}.

\textsuperscript{19} Ibid. Page 78.

\textsuperscript{20} Ibid.

\textsuperscript{21} Ibid.


2.1 FDI from a tax perspective

UNCTAD identifies four main reasons why FDI occurs. The first of them motivates FDI that seeks natural resource as a way of production, as the main idea behind the investment is to exploit raw materials such as mining, quarrying and petroleum\textsuperscript{24}. This might be a key factor to further on motivate developed countries to sign BTT with developing countries that are resourceful, as it would be advantageous for their companies to have a more stable investment environment as they seek and need natural resource. Moreover, there are certain raw materials that are essential to domestic production, and developed countries that lack those naturally, most certainly need to look for it abroad. Developing countries that have those resources are in advantage, and consequently have a greater bargain power while signing a BTT, as it is in the interest of the developed country to gain access to natural resources.

The second type of FDI is motivated by market seeking companies that see the foreign State as an alternative to export goods. Brazil, India and China, for example, are not developed countries and have a huge population, which means that companies are attracted by the size of the consumer market. Sometimes, the only way to access it is by entering in the local market with a local production, as there can be high transportation costs, consumer preferences specific to that country or market defined structures\textsuperscript{25}, as well as internal regulations. This is another important factor that attracts foreign capital, not only by accessing local markets, but specially because by investing via greenfield, for example, employment can raise and consequently the increase the population’s income that then will end up consuming even more goods. FDI can also be moved by strategic-asset-seeking, in which research and development are the main reasons for attracting foreign capital, as observed in the software sector in India\textsuperscript{26}.

At least, there is FDI motivated by efficiency seeking investors, which will establish part of their value chain in another country to improve its profitability. Profits will occur due to lower costs in production, such as cheaper labor force in developing countries. Mostly, this type of FDI is situated in the manufacturing and service industries, and China can be cited as


\textsuperscript{25} Ibid.

an example of country that has lower labor costs due to its huge population. This is the critical type of FDI that is motivated also by tax incentives and advantages experienced in foreign jurisdictions. As to be treated latter on in this article, companies motivated to invest abroad only by tax reduction purposes can end up being disfavored by the signing of a BTT.

In this sense, tax policies can have an effect on the allocation of investment across the world. Coase theory - which in my point of view enlightens the fourth motive of FDI - states that the phenomenon of multinationals arose by the possibility to lower the transaction costs associated with cross-border activity. Wherein tax advantages can derive from such operations and fuel back the strategy of using multinationals. Governments do so by working with the rates of return on foreign investors’ capital in order to attract them into their jurisdiction.

FDI will promote human development of the host country following the logic mentioned on the previous chapter, as well as by the capture of part of the profits that would be repatriated to the FDI exporting country. In a second stage, those profit shares would then be reinvested in the host country according to how local authorities and the government believes to be the best approach for the domestic population.

This idea is elaborated through the theory of tax distortion to investment. As an investor is concerned with his or hers share of it, the rate that matters to base a deal decision is whether where the after-tax rate of return will be maximized. States can then use this in their favor and create a tax friendly environment that will attract FDI and, consequently, promote human development.

However, if a State decides it’s tax policy unilaterally without coordinating it with the rest of the world or, at least, with important commercial partners, the risk of double taxation arises decreasing the incentives to invest abroad. This is because a country might decide to tax the same income as another country is already taxing, based on different criteria for that tax collection, and as if one adopts source and another residence taxation for that given situation.

27 Ibid.
30 Ibid.
In other words, double taxation occurs “if the same tax base (e.g. income or wealth) of a specific taxpayer (i.e., a person or enterprise) is taxed in two or more jurisdictions”\(^{31}\).

The after tax return would be decreased and it will become more advantageous to continue operating domestically or invest in another country that has a coordinated tax policy with the home State. As such, double taxation can be understood as an obstacle on the exchange of goods, services and cross-border movements of capital, technology and persons\(^{32}\).

Furthermore, Tax treaties can alleviate the problem of double taxation and consequently remove the obstacle for foreign investments and free flow of capital, as well as address other issues to be treated in the next chapters. To do so, tax treaties agree on the definition of tax liabilities, concepts, jurisdictions, the amount and way to calculate withholding taxes on repatriation, among other mechanisms to be elaborated next\(^{33}\).

Given this scenario, tax policy affects mostly FDI made by efficiency seeking investors that aim to lower their costs. As demonstrated further on this article, BTT can have an adverse effect on promoting those types of investment. Contrarily, I believe that the three other UNCTAD reasons to FDI might contribute to pressure a developed country in promoting a BTT with a developing country in order to promote a more stable legal framework, and give greater legal certainty to investors. However, it is unreal to think all of the world’s developing countries will present natural resources advantages, a large consumer market and advanced technology and research, which leaves a developed country with no great incentive to sign BTT focused only on the human development of the host country’s population. We must not rely simply on the goodwill, fairness consciousness and altruism of a developed country to help spontaneously a developing country.

In order to propose an effective tax mechanism that promotes development, first it is necessary to understand how taxation is dealt with in a global scale, analyze how contemporary tax treaty work, their main provisions and consequent current impacts on FDI, which ultimately promotes development as shown above.


3. An overview on Bilateral Tax Treaties

States can tax by virtue of their sovereignty, however their tax authority is not unlimited. For a situation to be subject to taxation there must be present either a personal or an objective connection between that person and the State to be collecting tax, also known as the nexus between them. Those connecting factors differ for individuals and legal entities. For individuals, the nexus factors can be their domicile, residence or citizenship. For corporations and legal entities, the factors usually include the place of incorporation and the place of effective management. As such, sufficient parts of the transaction need to be experienced in the taxing state or somehow connected to it\(^{34}\).

In international law practice, there are no significant limits on the tax sovereignty of states. In designing the domestic personal tax law, the national legislator can even tax situations when, for example, only a “genuine link” exists. It is only when neither the person nor the transaction has any connection with the taxing state that tax cannot be levied\(^ {35}\).

The same event might be taxed in two or more jurisdictions at the same time. Accordingly, persons that are subject to full tax liability based on the nexus of their residence, citizenship or similar nature criteria, can be subject to limited tax liability in another State, because this second limited tax liability applies to the income earned in that other state. In this scenario, if the first state of residence levies tax on the worldwide income of that person, the income will be taxed twice\(^ {36}\).

It is a given fact that Multinationals and cross-border investment are disseminated all over the world. Consequently, tax systems can overlap each other and encounter two alarming situations: (1) double taxation, as referred before, and (2) double non-taxation, considering stateless income incurred in circumstances that multinationals located in tax heavens with almost no productivity just for tax reporting reasons\(^ {37}\). This article focuses on the first one, as aversion to double taxation is a fundamental principle to development and FDI, due to the

\(^{34}\) Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2\(^{nd}\) edition. Page 27.

\(^{35}\) Ibid.

\(^{36}\) Ibid. Page 28.

significant discouragement to cross-border investment by the States when double taxation occurs.\textsuperscript{38}

There are two ways to address those issues, unilaterally by each State or engage in strategic interaction\textsuperscript{39} with other countries.\textsuperscript{40} Enacting unilateral measures to prevent double taxation will differ from State to State, and can be characterized by three types of resolutions: exemption of foreign-sourced income, tax credit for foreign taxes paid abroad on foreign-sourced income and deduction from the taxable base.\textsuperscript{41}

To completely avoid double taxation, however, countries need to harmonize their tax policies in order for them not to be conflicting and overleaping anymore, and a unilateral measure might not be enough. Forcing another State to comply with unilateral measures can involve extreme bargaining powers, economic and political pressures, which probably would not be enough to force another contrary country to comply such rules. Some countries are fond of the notion of reciprocity and are not satisfied with unilaterally granting exemptions if the other State is not willing to do the same. Unilateral measures can then be used for internal concerns in the application of methods established in the BTT, or to provide for situations that are not predicted or applicable to the BTT.\textsuperscript{42} Still, cooperation between two countries is necessary to avoid double taxation.

Bilateral Tax Treaties are agreements concluded between two State parties that aim to address taxation on people that, in a first moment, were liable to tax in both jurisdictions. BTTs determine the extent to which each state may levy tax, as they commit themselves to accepting an international law obligation and agree to relinquish, completely or in part, the incidence of taxes in certain situations. The contracting states therefore decide how the taxing policy will be like and are free to determine the rights they will give up, as those decisions will also influence domestic law.\textsuperscript{43} BTTS coordinate tax policies, standardize tax definitions and jurisdictions,

\textsuperscript{38} Ibid.

\textsuperscript{39} Some countries have entered into multilateral agreements to coordinate their tax policies and promote regional economic development. However, this option will be considered as a solution to the problems to be further on discussed resulted from from current BTTs.

\textsuperscript{40} Ibid.

\textsuperscript{41} Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2\textsuperscript{nd} edition. Page 30.

\textsuperscript{42} Ibid. Page 31.

\textsuperscript{43} Ibid. Page 32.
predicting how cross-border activity must be taxed by each State\textsuperscript{44}. BTTs are structured in very similar ways, and commonly follow these conceptual steps:

1) rules dealing with the time covered, commencement and termination dates of the agreement; 2) rules dealing with the taxes covered; 3) rules dealing with taxpayers; 4) rules applicable to different types of income, allocating tax capacity to one or other of the two jurisdictions which are parties to the BTT or sharing tax capacities between them; 5) rules excluding the operation of the beneficial aspects of the BTT in certain circumstances; 6) rules providing for double tax relief and 7) rules providing for procedural measures to assist in the resolution of disputes and in the collection of taxes. Also, their key functions are to alleviate international double taxation, eliminate international tax avoidance by prescribing rules for the allocation of income and deductions between related parties, for the exchange of information and for assistance in collection; and provide procedural rules for the resolution of tax objections and inconsistencies\textsuperscript{45}.

BTTs are negotiated between two States. According to LANG, 2013, the existing BTTs resemble each other. They follow a format which is internationally accepted, prescribed by the Organization for Economic Co-operation and Development (OECD model) or the version as modified by the United Nations (UN model)\textsuperscript{46} to be treated in great detail on the next subchapters. These model conventions serve as a starting point for the negotiations of BTTs, and States will then modify specific points in which they desire to deviate from the model\textsuperscript{47}.

### 3.1. OECD Model Convention

Influenced by the notion of a uniform approach to international tax law, a model of double taxation convention was presented to the Council of OECD in 1963. Since then, OECD has been reviewing its Model Convention in order to stay updated with changes in business transactions\textsuperscript{48}.


\textsuperscript{46} Ibid.


Many States use this model as a basis for their BTT negotiations, in order to save transactional costs of drafting a treaty from scratch. As mentioned by Oliver Hood (2010): “The use of the OECD Model Convention may significantly reduce the costs and accelerate the negotiation process. OECD Members can then enter reservations on specific rules from the Model and adapt them as they wish to their own economic interests and peculiarities of their laws and systems\textsuperscript{49}, providing for some flexibility in the Model.

The principal that governs the entire model is based on the notion that the allocation of taxing rights stems from the economic link of income and capital\textsuperscript{50}. Therefore, it tries to specify rules for each situation experienced by countries and gives the best solution and alternatives aiming to harmonize tax treaties concluded by OECD members. The instruments the model uses to do so is by providing clarifications and standardizations, trying to reach common solutions to countries in identical cases of double taxation\textsuperscript{51}. Moreover, the OECD Model and its commentaries are a source for interpretation of tax treaties, as courts from different jurisdictions may seek common interpretations on such grounds\textsuperscript{52}.

The structure of the OECD Model can provide an overview of important matters that are addressed in a BTT. Chapter 1 provides the scope of the Convention and brings important definitions such persons and taxes covered in the treaty. The OECD model classify persons as all of those who are residents in one or both parties. The taxes dealt with are on income and capital, provided in Article 2 of the model. Chapter 2 brings more definitions established in this chapter, as well as the terms referred to in the treaty. It is important to notice that other terms are also defined in the respective articles of such matters (ex. Art. 11 (3) defines interest and article 12 defines royalties). Chapter 3 handles taxation of income of different categories. Chapter 4 is about taxation of capital. Chapter 5 contains the methods for eliminating double taxation specifically, as it brings two methods to be adopted by the residence State, via

\textsuperscript{49} Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2\textsuperscript{nd} edition. Page 34.


\textsuperscript{51} Ibid. Page 18.

\textsuperscript{52} Ibid. Page 55.
exemption or credit. Chapter 6 provides special provisions in relation to discrimination, exchange of information and mutual agreement procedure. Chapter 7 regulates the BTT entry into force and how it can be terminated.

### 3.2. United Nations Model Convention

The General Assembly, the Economic and Social council of the United Nations and the United Nations Conference on Trade and Development expressed their desirability in the promotion of more inflows of FDI to developing countries by their resolutions over the years. They share the view that FDI is economically and socially beneficial to such developing economies.

The UN Model was created from such desirability to encourage FDI and the conclusion of BTTs between specifically developed and developing countries. The Economic and Social Council of the UN, through resolution 1273 (XLIII) decided to attend the request of Secretary-General. It consisted in the elaboration of ways and means for facilitating the conclusion of tax treaties between developed and developing countries, as well as the formulation of guidelines and techniques for the BTT to be acceptable to both groups of countries in different stages of development. “The main objective of the revision of the UN Model were to take account of developments since 1980 in the globalization of trade and investment and in the international tax policies of developed and developing countries.”

In comparison to the OECD Model, the UN Model represents a compromise between the source and residence taxation, but still tries to give more importance and make the residence criteria prevail. Moreover, the articles of the model:

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53 The residence state excludes from the taxable base the income derived or the capital owned in the other state. In this case the taxing rights lie only with the source state. Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2nd edition. Page 74.

54 The taxable base in the residence state remains unchanged. The foreign income is still included in the domestic taxable base. However, the taxes levied in the source state are credited on the taxes levied in the residence state. Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2nd edition. Page 75.


56 Ibid. page viii.

57 Ibid. page xii.
Are predicated on the premise of the recognition by the source country that (a) taxation of income from foreign capital would take into account expenses allocable to the earnings of the income so that such income would be taxes on a net basis, that (b) taxation would not be so high as to discourage investments and that (c) it would take into account the appropriateness of the sharing of revenue with the country providing the capital. In addition, the UN Model embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either foreign tax credit or exemption as in the OECD Model.\(^{58}\)

Just as the methods to avoid double taxation mentioned in the passage, in almost every respect the UN Model resembles the OECD Model. Deviations are punctual and only with respect to certain issues, as well as a general preponderance of source-based taxation. Significant differences can be identified in art. 5 (permanent establishment), art. 7 (business profits), art. 9 (associated enterprises), art. 10 (dividends), art. 11 (interest), art. 12 (royalties), art. 13 (capital gains) and art. 21 (other income). These variations try to ensure that the source country retains certain taxing rights.\(^{59}\)

### 3.3. Current tax treaties impact on foreign direct investment

Many might think that treaties increase investment, since they indicate cooperative taxation by the contracting parties. In reality, they have a dampening effect on FDI motivated by efficiency seeking investors that are driven by tax avoidance and tax-saving strategies.\(^{60}\) Bruce A. Bonigen and Ronald B. Davies, (2009) presented empirical results on treaty formation.

\(^{58}\) Ibid. page xiv.

\(^{59}\) Example: The OECD Model provides that royalties are taxed exclusively in the state of the recipient’s residence, to the exclusion of the source state (art. 12 OECD, Model, cf. m.no. 305 et seq.). According to the UN Model, royalties may also be taxed in the state in which they arise. The UN Model does not establish a tax rate for the source state but leaves this question open. The rate is to be established in bilateral negotiations. The UN Model’s principle regarding source taxation for royalties considers the situation of the developing countries: know-how is provided primarily by entrepreneurs of developed countries to enterprises in developing countries. Only rarely does the opposite occur. Thus, developing countries want to retain the right to tax remuneration paid in return of know-how. In. Lang, Michael. Introduction to the Law of Double Taxation Conventions. Published by Linde Verlag. 2013. 2nd edition. Page 33.

by OECD members, and suggested that the increase FDI activity most likely does not occur due to treaty formation, and may in fact decrease it.

In relation to the harmonization of tax definitions and jurisdictions of treaty partners, a treaty can have a positive impact towards avoiding double taxation. It happens by, for example, generating a definition to permanent establishment, which will then fix the previous problem of two different definitions for the concept provided by each countries’ domestic law.

The standardization of tax definitions, itself, has a potential to increase FDI as demonstrated empirically by Hines (1988). In his studies, he discovered that the Tax Reform Act of 1986, which revised U.S tax definitions, led to an increase in U.S outbound investment. In my opinion, per se, the harmonization of tax definitions in BTTs are an important feature and actually promote FDI, which demands further understanding of what really has an adverse effect on foreign investment and how to better address it.

BTTs affect taxation of multinationals by providing rules that, following the OECD model, either exempt foreign-earned profits from domestic taxation or offer foreign tax credits when estimating the domestic tax bill. Also, treaties reduce maximum allowable withholding taxes on some types of remitted income, such as dividend payments, royalties and interest payments. As seen in the following excerpt, these provisions, in itself, do not have a negative impact on FDI.

If these reductions in the withholding tax reduce the tax burden on overseas investment, this should increase FDI. Note that even though withholding tax rates fall under a treaty, this does not imply that tax receipt from inbound investment must be declined. Since withholding taxes can be tailored to the specific investment from a treaty partner, it may be possible to set tax rates which encourage tax-sensitive inbound investment and actually raise total tax receipts.

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63 Ibid. Page 464.
The critical negative impact on the promotion of FDI occurs due to improved information exchange commitments made between partner governments that accompany the treaties. This specific feature of the treaty aims to contest tax evasion, which will then have an influence on current investments being made for tax avoidance and minimization reasons and even on future investments that would be solemnly driven by tax cost reductions.

In this situation, it is important to notice that the contracting States would have an increased tax revenue due to improved information exchange between governments. Persons that before were evading tax would be under the radar of tax authorities and then forced to comply with their obligations and sanctions. However, first, there are no assurances, which State would collect those once avoided taxes, which can be submitted only to the developed countries’ jurisdiction – not promoting investment, and neither reinvested in the developing economy. Second, there is still the problem of tax revenue collected by the government and not necessarily reinvested in the country towards human development. Corruption and inefficiencies are still present in developing countries in general, and that is why, in my point of view, FDI via greenfield is the best way to ensure development by the creation of infrastructure and permanent jobs.

It is hard, though, to argue against information exchange, although it has a negative impact on FDI driven by tax costs reduction and fraudulent tax avoidance. It is, in itself, a noble commitment penetrated with a sense of justice, fairness, and is a way to discourage crimes of tax evasion. As such, it should be addressed in a separate instrument from the BTT that primarily has the focus of eliminating double taxation and promoting development.

Among the purposes of information exchange between tax authorities, the ones that stand out are the goal to reduce a firm’s ability to engage in transfer pricing and tackle the usage by residents of offshore accounts, designed to gain advantages provided by banks located in low-tax or even no tax jurisdictions and banking secrecy laws. When incorporated into a

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64 Ibid. Page 464.


treaty, developed countries introduce information exchange as a way to shift from source-based towards residence-based taxation.\textsuperscript{67}

The United States has already dealt with tax evasion by US persons separately through the enacting of the Foreign Account Tax Compliance Act (FATCA)\textsuperscript{68}. This might reveal that developed countries can address tax evasion throughout a separate mechanism, unilaterally or contracting a separate treaty concerning only this topic. Although information exchange affects FDI, it should be negotiated without influencing rights of a developing State to proceed with source-based taxation on certain situations.

While signing a new BTT, countries can predict and foresee the impact of information exchange between tax authorities provided in another instrument and then provide mechanisms in the other sense, trying to outstand the decrease in FDI with pro-investment measures and provisions, as to be shown latter on.

A significant consideration was made by Blonigen and Davies (2009) showing that the use of current BTTs to promote foreign investment is a myth. This because they are intended to decrease administration costs, lower tax evasion and to further on extract concessions from their treaty partner making use of bargain power due to a better political and economic position. As to be observed in this passage:

We tested whether treaty formation by OECD members is associated with changes in FDI activity. Using data from 1982 to 1992, we examine the behavior of FDI stocks and FDI flows. Initial results indicate that treaties seem to increase FDI. However, this result is suspect because the sample includes many older treaties which were enacted well before out data series begins. (…) Here we found that new treaty formation is not significantly correlated with FDI activity. In fact, when we restrict ourselves to just those countries that enacted a treaty during our sampling period, we find that FDI stocks are significantly decreased after treaty formation (…) recent treaties are not geared towards the promotion of FDI but rather towards reduction in tax evasion.

\textsuperscript{67} Idea elaborated by Daniel N. Shaviro, New York University School of Law professor. Email: daniel.shaviro@nyu.edu

\textsuperscript{68} FATCA was enacted by the United States government as a response to tax evasion and omission of taxpayer revenue. Its prior goal is to monitor citizens and businesses held by North Americans who hold assets in foreign financial institutions and other investment vehicles. Every country that has a relationship with an US person is bound to comply with FATCA’s terms, as the single fact that they interact and hold accounts for American’s living abroad already make them a target of this policy. FATCA Information for Governments. IRS. http://www.irs.gov/Businesses/Corporations/FATCA-Governments: Date of access: Oct. 26, 2015.
While these results do not mean that treaties cannot be used to increase FDI they do suggest that the FDI promotion argument is suspect\(^{69}\).

This excerpt critically attacks the wrongful notion that BTTs are contracted to promote FDI. The way they are currently drafted does not correspond this goal, and serves for other decent objectives like avoiding tax evasion, transfer pricing and treaty shopping. However, as shown in section 2.1, tax does have an impact on FDI and, in my option, BTTs can be designed in a way to increase FDI and consequently promote human development. The question is how to turn BTTs into such mechanisms.

An effective tax system is critical for development. The developed countries, and increasingly the emerging economies as well, are conflicted in assisting developing countries because addressing many of the issues in developing countries’ revenue mobilization will result in taxation of local champion MNEs (Global multinational enterprises) or state-owned enterprises. Not surprisingly, in light of its membership, the G-20 does not probe the linkage between developed and developing countries’ tax policies allowing tax competition and their impact on developing countries’ ability to mobilize revenue\(^{70}\).

4. Potential tax alternatives to promote development

First, we shall consider if there is still a need for developing countries to conclude BTTs at all, as the way they are drafted today present issues and harsh consequences on FDI, as mentioned above. The view of Pasquale Pistone\(^{71}\) presents an important factor to be considered, which is that tax treaties are, until now, the one instrument that is capable of introducing \textit{a limitation in the exercise of taxing powers that} \(^{72}\) prevents the developed countries from

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\(^{72}\) Ibid.
maintaining the otherwise traditional scope of their sovereignty. The need for tax treaties is extracted by interests of both contracting countries.

There are numerous proposals and scholar researches in the field of tax reform to solve issues pending on the current international tax regime. This article focuses on two potential alternatives that might increase FDI activity and consequently promote development in low-income countries with low human development rates. First, tax sparing provisions will be detailed and analyzed, and, second, financing mechanisms via BTT.

4.1. Tax sparing treaty provisions aligned with tax incentives.

In order to increase FDI in low-income States they tend to offer tax incentives. The effectiveness of such encouragements can be challenged by States that take measures to not recognize that incentive and consequently reach the same practical result as if the incentive was never given by the developing country. Tax sparing provisions, in this way, come to ease such problem.

A tax sparing provision, as defined by Kim Brooks (2009), can be included in a BTT and preserve the tax incentive given by one of them. In order to do so, the tax owed to the developed country is reduced by the amount of tax that would have been paid to the developing country, but for the tax incentive. "Tax sparing provisions preserve the tax incentives granted by one jurisdiction by requiring the other jurisdiction to give tax credit for the taxes that would have been paid to the low-income country if the incentive had not been granted."74

Some States have in fact included tax sparing provisions in their BTTs by 1963, which was when the OECD model was released. The model, however, did not explicitly endorse this type of provisions.75 In a commentary of article 23, tax sparing was indirectly mentioned as it was recognized the possibility for a developing state to grant tax incentives. In this specific case, the model then suggested that the treaty partner might consider exemption from income product of the encouraged activity in the developing country, or agree on a tax sparing


75 Ibid. Page 8.
arrangement, which would recognize credit for tax that would have been collected if no relief was granted. The U.K was one of the countries that included tax sparing provisions in their BTTs.76

Except from that, the OECD has never formally endorsed tax sparing provisions in the model. In the next revised version, special attention was brought to the same commentary of article 23, emphasizing the need to draft tax sparing provisions in the narrowest form possible and with great caution, limiting its scope. Such reluctance may be due to the influence the U.S had on setting the OECD’s tax policy, as this country has a strong opposition to such approach. Moreover, as the OECD was essentially drafted to the application between developed / high-income countries, developing countries might have not been relevant and taken into account in its planning.77

The UN Model, although designed to better attend developing countries, it did not show strong support for tax sparing provisions. Indeed, the version released in 1980 was a mere acceptance of the commentaries on the 1977 OECD model.78

When the draft UN model treaty was released, the absence of an express provision on tax sparing arrangements was interpreted by numerous commentators to reflect either a continued bias in favor of high-income countries or a failure of those countries to appreciate the distinct need of low-income countries.79

As every other method, the use of tax sparing provisions might not be too significant and even be subject for abuses and preserve effects to not pay taxes at all, for example. However, its core purpose should not be ignored, and otherwise developed into an effective provision and tangle the issues pointed out by Brookes (2009). The increase of foreign investment in developing countries by the use of tax incentives is undeniable, as shown in the previous sections. If tax sparing provisions in a step towards that, it should be well understood and supported.

One of the points brought up by Brookes is when she argues that tax sparing provisions are not effective in certain situations. For example, the ones in with a multinational decides to operate through a subsidiary corporation, which will not be a resident of the developed country

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76 Ibid.
77 Ibid. Page 9.
78 Ibid. Page 10.
79 Ibid. Page 10.
and then, when profits are paid back to parent company in the form of dividends, issues arise whether how they will be taxed and if they will be exempted from taxes of business income of foreign affiliates.

Furthermore, even when tax sparing provisions might be effective, such as once income is repatriated and the full resident country tax would have to be paid, that State might defer tax until income is repatriated. This means that tax liability in the future might be close to zero, and therefore there shall be no need for tax sparing provisions\(^80\). I disagree with that argument, when making this assumption, Brooks ignore all other motives a company might have to repatriate its income, still remaining some significance for tax sparing provisions to be made. At least the enterprise can have the option to remit its income if it is important to the core of business not indefinitely leave it abroad. The absence of tax sparing can prevent FDI if repatriating income is relevant to that activity.

Taken this into consideration, there is still potential for tax sparing provisions to promote FDI and consequently human development. It is necessary that a stronger support be shown in the OECD or UN model, formally endorsing such practice. As well as the need to draft it as much detailed as possible, predicting all types of activities (subsidiaries and branch, for example), tax incentives and procedures to be adopted. The importance of the evidence of taxation in the other contracting State, also needs to be emphasized, or the proof that such tax incentives exists and is applicable to that company in such circumstance. These should be turned into a legal requirement, so that tax authorities can verify the legality of the tax benefit, avoiding abuses of tax sparing provisions. This specific point could also be mentioned and work in accordance to the separate treaty about information exchange, following the logic elaborated on the section above.

Luís Eduardo Schoueri\(^81\) also offers an interesting perspective on tax sparing, as in his point of view, capital export neutrality is not the only target for international taxation (one of the reasons why those type of provisions were criticized by OECD’s reconsideration of tax sparing\(^82\)). His theory is also based on the fact that investors will not invest in developing countries unless if their profits and remuneration will be high enough to outstand gaps of infrastructure. That is why a difference in the interest rate is justified.

\(^{80}\) Ibid. Page 5.


\(^{82}\) Tax Sparing: A Reconsideration. Issued by the Committee on Fiscal Affairs. 23 October 1997.
He also believes that tax sparing clauses are not a favor (or aid) granted by the residence state, as BTTs are negotiated between two jurisdictions which will then share taxing powers. Automatically by entering into a BTT both countries recognize each others jurisdiction to levy taxes, and decide in a free will to limit it.

One can see that tax sparing (especially the matching credit approach) is a mechanism aimed at correcting the distortion in the basic credit mechanism. By means of a tax sparing clause, the residence state recognizes the source state’s right to tax or not to tax an item of income which was granted to its jurisdiction. Thus, a tax sparing clause (matching credit) is not a favor granted by the residence state. By means of its adoption, the residence state simply confirms that it has no taxing right on an item of income which was granted to the source state.83

4.2. Tax treaty finance

Mitchell A. Kane84 developed a proposal that moves towards the goal of this article. It consists in the surrender of a portion of the tax authority by a developing country, in order to receive in exchange an upfront capital transfer from the developed country, to be investment in its economy to further on promote development. In a second stage of his proposal, the developed country would gain back some portion of the capital he lent by the exercise of tax collection established in the treaty, which would result in an expanded tax authority. Kane, in his article also suggests modifications to the OECD Model Treaty 2010, which puts his proposal into practice, to be observed in the appendix.

Kane (2012) reaches this idea by first realizing the problems of debt finance through syndicated bank loans and securities, that is why FDI, as equity finance, is so promising. In his words, the proposal is justified and would work as noticed in the following passage:

At the heart of the proposal is the idea that where a developed country provides external finance to a developing country, the typical allocation of taxing rights over productive investment across the two countries ought to be flipped. Under widely accepted norms, the primary right to tax runs according to a source


principle. Thus, if a multinational firm in a developed country deploys productive capital in a developing country (by building a factory, for example), the primary right to tax the return to that activity would run to the country where the factory is physically located rather than to the country where the parent firm is based. My basic suggestion is that developing countries should surrender that primary taxing right. The surrender would not be given for free, of course, but rather in exchange for an upfront capital transfer, which comprises the basic financing element of the proposal. More specifically, one can break the proposal into two discrete components. 

The developing country will benefit from that capital transfer and then reinvest it into its economy in order to attract FDI and promote human development by improving infrastructure, work force qualification, among others. In my opinion, though, in order to assure that amount of money would be beneficial to attract FDI and to the countries population, it is necessary to specify channels of delivery for the capital transfer and specific projects to be complied with. Development experts could help in this sense, and estipulate guidelines for the usage of the capital transfer, how to me administrated and follow certain compliance standards to avoid developing countries’ issues like corruption.

This finance implicates the necessary use of a tax treaty as it will reorder existing taxing rights and further on provide the legal mechanisms in which the receiving country would pay back the finance. Kane emphasizes the need of a requirement to prevent developing countries in favoring third-country firms by offering lower tax rates, thus damaging the ability of the capital transferor to gain back his capital finance.

Advantages of this proposal are experienced by the reduction of costs from having the developed country recoup original payment by the collection of taxes directly under the tax system articulated in the BTT, also by removing the possibility of costly sovereign defaults, and, lastly, by providing a mechanism that addresses tax competition.

I would still highlight the need for a provision in the BTT that stipulates a time limit for that expanded tax authority of the developed country, in order to not perpetuate this relationship long after the capital transfer has been paid. Thus, after a certain period of time - to be calculated

85 Ibid. Page 258.
accordingly to projections of how long would it take for the amount via tax collection to be equal as the capital transfer – the BTT should be renegotiated and reorder taxing rights. This is also important to not perpetrate an eternal dependence relation from the developing country to the developed one. The idea is that after the capital transfer is made and several years of FDI activity and tax collection to recoup that amount the receiving country will be able to be independent and recover some of it’s taxing rights, not needing to be permanently be in a position that would, in a future, offer “free” tax revenue to the other country.

5. Conclusion

As demonstrated through this article, FDI has a great potential to promote human development by the creation of jobs, infrastructure, markets competition and technological advances. In order to attract FDI, countries make use of their tax regime and lower investors’ tax costs. The goal is to overcome the difficulties of investing in a developing country by gaining tax benefits on the other hand.

Double taxation is understood as a barrier to cross-border investment and together with other concerns of tax evasion, transfer pricing and treaty shopping, motivated countries to sign BTTs. These treaties follow an internationally accepted format prescribed by the OECD model and by the UN model. The models generally suggest the harmonization of tax concepts and delimit each State’s jurisdiction to levy taxes.

However, as studies have shown, the way BTTs are drafted currently do not effectively promote investment in developing countries, which then opens space to question the signing of BTTs and how to better promote development. A suggestion that might contribute towards FDI incentives would be to address information exchange between tax authorities in a separate instrument. Then, specific BTT will be designed only to promote development and be able to dialog with other agreements between governments information exchange.

This article further on analyses two different proposals that can even be combined in a treaty. First, tax sparing provisions are still an option to preserve incentives given by developing countries to attract FDI. To improve their use, they can be narrowly drafted and predict all types investment situations, considering, for example, operations via branch or subsidiary. A formal endorsement from the OECD or UN would help pressure countries on adopting these types of provisions.

Another alternative would be to finance a developing country by an upfront capital
transfer made by a developed country. In a second moment, the developed country would then recoup that amount by collecting taxes. This finance would be better represented via BTT specially because it reallocates taxing rights, and, in my opinion, would have to be reformed again after a certain period of time. Through Mitchell Kane’s proposal, developing countries would bypass common issues that arise with ordinary types of financing a State.

There is still a possibility to turn BTTs into an effective mechanism to promote FDI and consequently development. Taxation does affect investors decisions and should be considered as an important tool to improve a country’s economic and social welfare.

6. Bibliography


7. Appendix

Proposed Modifications to the OECD Model Treaty (2010) by Mitchell Kane

Article 3
General Definitions

1. For the purposes of this Convention, unless the context otherwise requires:

(i) the term "Transferor State" means the Contracting State that has transferred capital to the other Contracting State pursuant to a Development Finance Agreement;

(j) the term "Transferee State" means the Contracting State that has received capital from the other Contracting State pursuant to a Development Finance Agreement;

(k) the term "Development Finance Agreement" refers to any agreement whereby one Contracting State transfers capital to the other Contracting State on condition of acceptance of the terms of paragraph 1(a) of Article 7.

Article 7

Business Profits

1. Until such time as the conditions specified in paragraph 5 have been satisfied:

(a) Profits of an enterprise of the Transferor State, or of an enterprise of the Transferee State that is controlled by an enterprise of the Transferor State, shall be taxable only in the Transferor State.

(b) Profits of an enterprise of the Transferee State that is not controlled by either an enterprise of the Transferor State or an enterprise of a third state shall be taxable only in the Transferee State unless the enterprise carries on business in the Transferor State through a permanent establishment situated therein. If the enterprise of the Transferee State carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in the Transferor State.

(c) Profits of an enterprise of the Transferee State that is controlled by an enterprise of a third state shall be taxed by the Transferee State at a rate equal to [the target rate.]

(d) If an enterprise of a third state carries on business in the Transferee State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 shall be taxed by the Transferee State at a rate equal to [the target rate.]
After the satisfaction of the conditions specified in paragraph 5, the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with paragraph 2 may be taxed in that other State.

5. For purposes of paragraph 1, the conditions in this paragraph will be treated as satisfied:

[on the date that is _ years after the execution of a Development Finance Agreement.]

[on the date upon which the Transferor State certifies that _ of profits have become taxable by the Transferor State where, but for the terms of paragraph 1(a), such profits would have been taxable by the Transferee State.]