THE ROLE OF DOUBLE TAX CONVENTIONS IN INTERNATIONAL TAX LAW

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Abstract: This article deals with position of double tax conventions on income and capital in international tax law based on two issues. Firstly, what is the purpose of these tax treaties[1] nowadays? Is it only an avoidance of international juridical double taxation or tax treaties also stimulate foreign direct investments and international trade? Secondly, what is the future of double tax conventions? In order to answer above mentioned questions the author will briefly look at the past and present of double tax conventions. The answers will provide not only a description and analysis but also an evaluation. Taking into account available limited length for this paper, it is not possible to discuss the position of double tax conventions in the international tax law in more detail. The author can only introduce a number of highlights.

Keywords: double tax conventions, international tax law.

INTRODUCTION

At the present time, which is characterized by ongoing global financial crisis and problems with the amount of public debt in the states of the Eurozone, it is significant, that economic activities of individuals and legal entities are increasingly global. Importance of foreign taxpayers has increased with a development of international trade and investment and also with increasing labour mobility. These are the individuals who make business or work in another country than in their tax residence. On the other hand, the power to impose and collect taxes remains a matter of national sovereignty of the states.[2] They use it and try to tax economic activity carried out within their territory, regardless of the tax jurisdiction of individuals or legal entities. As a result of the fact that each country applies in its territory full power of taxation in the field of direct taxation existence of international double taxation occurs.

In international tax relations the problem occurs, if under national legislation, there is an overlap of right to tax an income in a state of taxpayer's residence (state of tax residence) and a state of a taxpayer's income country of origin (state of source of the income). If this happens in practice and both countries use its full powers of taxation, the income will be taxed in both countries, i.e. in a state of tax residence of a taxpayer and state of source of the income.

International double taxation causes in a global scale disruption of economic relations and creates barriers for development of international trade and investment. Double tax conventions serve as a tool for connecting the economies of the contracting states and play an important role in supporting economic growth of these countries. According to the author, one of the main reasons of conclusion of tax treaties is an attempt to avoid international double taxation which is caused by a fact that each state applies full power of taxation in the field of direct taxation within its territory. At the same time these treaties perform other tasks that are discussed in this article, having a significant impact on the development of economic relations between the states.

1 PAST AND PRESENT OF DOUBLE TAX COVENTIONS

The first tax conventions that were intended to prevent double taxation of income were concluded between the European states in the early 20th century. After the First World War, there was a boom in their conclusion, which was associated with the development of international trade and activities of the League of Nations in this area. At the expert level, more attention had been paid to the issue since 1920, when the Fiscal Committee of the League of Nations invited leading economists to solve a problem of double taxation. In the following years several conferences were convened with an aim to develop a multilateral treaty. However, the States rejected a possibility of a single multilateral treaty and supported creation of legally not binding convention which could be a model for bilateral tax treaties. Work of special commission of the League of Nations resulted in series of model conventions published in the years 1928, 1935, 1943 and 1946.[3] It can be observed that although international taxation has become more intricate and tax legislation in this area more complex, current model treaties and double tax conventions are based on the above mentioned conventions.

In 1961 the Organisation for Economic Co-operation and Development was established and published its first Model Tax Convention on Income and on Capital[4] ("OECD Model Convention") and the Commentaries thereto in 1963. Since then the OECD Model Convention had been continually updated, the first revision was made in 1977 and the last in 2010. After the changes in global economic environment in the 90´s of the last century, mainly due to the liberalization of trade and services, number of tax treaties grew quickly. Although the states are not obliged to use the OECD Model Convention in their bilateral negotiations, more than 3,000 tax treaties are currently in force, inspired by the provisions of the OECD Model Convention.[5] This high number is caused by a fact that developed countries enter into tax treaties only on the basis of the OECD Model Convention but also by a fact that less developed countries use them in their mutual bilateral relations as well.

Historical development of creating international tax rules on avoidance of double taxation was not without conflict. The most important issue related to a problem which principle should be used for income taxation. Is it preferable to tax under a principle of tax residence or under a principle applicable within a state of source of income? Generally it was and still is true that developed countries are in favour of the principle of tax residence due to the fact that they belong to the exporters of capital and investment funds. Less developed or developing countries prefer the principle of taxation by state of source of income. The existence of two different model conventions is nowadays an evidence of the conflict.

From the current OECD Model Convention, as well as its predecessors, it results that taxation under the tax residence of a taxpayer is being favoured. In respect of the foregoing it is not a surprising finding. Organisation for Economic Co-operation and Development consists of the most advanced countries in the world that have similar political and economic interests whose expression is also a very close international tax policy. According to the author, the OECD Model Convention is based on a fact that it is trying to prevent or at least mitigate double taxation in the state of tax residence by applying the methods for elimination of double taxation. It also simultaneously limits power of a source state as it excludes right of a state to tax a certain income or determine lower tax rates than usual in a state of source of the income. The United Nations, which involves representatives of all countries of the world, created a competitive model, i.e. Model Double Taxation Convention between Developed and Developing Countries ("UN Model Convention") which incline to the taxation by state of source.[6]

[1] In the article term tax treaties is used as a synonym for double tax conventions on income and capital.
[2] This statement is not absolute, since states that are members of international political-economic integration structures such as the European Union, had to give up a part of their tax sovereignty prior to commencement of membership in these structures. For Member States of the European Union it mainly meant subordination of common rules in the field of indirect taxation.
[3] See more: RIXEN, T. – ROHLFING, I. *The Institutional Choice of Bilateralism and Multilateralism in International Trade and Taxation.* In: International Negotiation, Vol. 12, No. 3, 2007, pp. 394-395.
[4] OECD Model Tax Convention on Income and on Capital [online]. [cit. 2012-12-28]. Available at: [http://www.oecd.org/tax/taxtreaties/47213736.pdf].
[5] More in: http://www.oecd.org/about/history/
[6] UN Model Double Taxation Convention between Developed and Developing Countries [online]. [cit. 2012-12-29]. Available at: [http://unpan1.un.org/intradoc/groups/public/documents/un/unpan002084.pdf].

2 PURPOSE OF DOUBLE TAX CONVENTIONS

It can be declared that model conventions serve as a basis for bilateral negotiations and modify the standards for solving international tax issues including elimination of double taxation but they do not predetermine specific content of tax treaty. It depends on an outcome of the negotiations and, except for avoidance of double taxation of income; it typically includes other issues which will be analysed below.

2.1 Tax treaties and avoiding of double taxation of income

International double taxation occurs for several reasons. The most common case is when incomes of an individual or legal entity are taxed in a state in which persons are deemed to be tax resident and at the same time in a state which is source of these incomes. As a result, tax burden of the taxpayers is disproportionately high and it reduces profits and competitiveness of the persons. It can be said that this happens due to diverse legislation in different countries (different determination of tax institutes, types of income, fiscal obligations, etc.). It results from the application of tax sovereignty of the states while making tax legislation. From these reasons the main argument for contracting double tax conventions is an effort to resolve potential conflict between the states in the application of their tax claims.

As indicated above, each state, as an independent entity, unlimitedly sets conditions for collecting taxes from taxpayers within its territory. However, globalization of world economy and impact of the institutes of international tax law is forcing the lawmakers to take into account international trends in creation of tax legislation. It is impossible to omit presence of European tax law and case law of the Court of Justice of the European Union on tax legislation of the Member States. We can not ignore the fact that increasing mobility of the persons and capital, together with often complex and opaque tax laws are liable to create newer procedures by which taxpayers tend to minimize their tax liability.

At this point it is important to mention that the states adopt national legislative measures to avoid international double taxation. Currently, the most common means are special provisions of tax laws governing the methods which avoid taxation of the same income in two states. It is an exemption method and there is full exemption and exemption with progression, and tax credit method with two possibilities, i.e. full credit and ordinary credit.[7] On basis thereon the state of taxpayer's residence gives up its entitlement to a tax if specified conditions are met. The author believes that internal measures of the states can not effectively and comprehensively resolve the issue of international taxation of incomes. They do not protect tax residents against high taxes in other states and do not affect equitable distribution of tax revenues between the state of tax residence and the state of source of income. They also do not prevent a person to be considered as tax resident in two countries and thus to be taxed in two states. This is mainly due to limited scope of national tax laws but also due to inability to affect the potential adversarial legislation in another state.

It should be noted that in professional circles there has never been consensus on the best and most efficient mean that would avoid international double taxation. Due to complexity of this issue it is not surprising. Since the end of the 19th century the states had made effort to intensify economic relations through tax treaties. During the 20th century they were looking for ways to avoid international double taxation on bilateral and multilateral level. Therefore at present, bilateral conventions between states for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and capital (i.e. double tax conventions) are considered to be the most effective tools.

Proposed solutions are now included in the above-mentioned model conventions and that is typical for international taxation and, particularly, for double taxation. They are based on principles that have been adopted in the conventions of the League of Nations and in the first tax treaties concluded between the states, mainly after the First World War. The principles are currently codified in relevant articles of the OECD Model Convention and UN Model Convention. The right to tax different types of income is allowed to either state of source of income or state of tax residence. Based on this, there is a general rule that the state of tax residence must provide relief from taxation in a case of full or limited taxation in the state of source. This can be done, if a tax paid in a state of source is credited against a tax due in home country or by exemption of income taxed in a state of source from the calculated tax in a state where person is resident for tax purposes. It should be emphasized that bilateral tax treaties do not contain complex rules for taxation but basically determine which state has the right to tax a particular income. If tax authority is identified under the tax treaty, a state applies national tax and legal regulation on relevant incomes which are determined in tax treaty. It can be said that double tax conventions enable coordination of application of different national tax laws which regulate sovereign tax systems of the states. International tax law, with tax treaties as its basis, thus gain importance and is gradually being set apart as a separate branch of law.

2.2 Other objectives of double taxation conventions

In addition to avoidance of international double taxation, the states in tax treaties also try to solve other issues related to the regulation of international legal tax relations. The author believes that one of the goals of tax treaties is to stimulate and facilitate international business and to intensify cross-border movement of the persons, goods, services, and capital by avoiding international double taxation. For this purpose it is necessary to work constantly to improve contractual provisions and regulations.

In recent years, in international tax relations, apart from the fight against double taxation, there has been an effort to eliminate cases of double non-taxation. Such situations happen due to the opportunities given by inconsistent national tax laws and tax treaties. The issue of preventing tax evasion, especially during current economic crisis, gains a new dimension, and it is very difficult to distinguish between legal and illegal form of reducing tax liability. If contracting states applied different rates of income tax, provisions of the treaties could be used for tax planning that would result into legal reduction of tax base of the taxpayer's worldwide income to the lowest possible level. Intensive cooperation of the states, based on the mentioned conventions, can reduce success of the taxpayers to evade tax obligations and increase revenues for state budgets.

The reason for concluding tax treaties is also the fact that they provide additional comparative advantages. They reduce administrative costs of taxation, e.g. through an exchange of information between competent national authorities. Provisions of tax treaties relating to definitions, rules of taxation, and methods for elimination of double taxation contribute to legal security of foreign taxpayers and reduce the cost of tax and legal services.

Double tax conventions concluded between the states also contain provisions designed to ensure equal treatment of foreign taxpayers as domestic individuals and legal entities, regardless of their tax jurisdiction.

During negotiating developed countries apply their stronger political and economic status which enables them to benefit at the expense of the other contractual party. The state of tax residence tends to limit the state of source and its right to tax income coming from that state. The motive for this action is the

[7] See more: BABČÁK, V. *Slovenské daňové právo.* Bratislava : EPOS, 2012. pp. 98-100.

fact that the restriction of taxation of incomes in the state of source reduces the tax burden on persons with tax residence in another state. The state of tax residence gains a larger share of tax revenues and its investors face better tax conditions in another state. Obvious disadvantage of tax treaties for less developed countries is potential loss of tax revenues, if principle of taxation by the state of tax residence of the taxpayer is preferred in tax treaties. For these states, in bilateral negotiations, it is difficult to impose equall taxation under the principle of source of income which would fairly split tax revenues and reflect true economic reality. Tax powers of the states should be divided in the tax treaties equally and their performance should not lead to discrimination against taxpayers or other restrictions.

Double tax conventions also have impact on a flow of foreign direct investment among the parties to the convention. Several studies have considered them to be an effective mean of promoting foreign direct investment ("FDI") because they lead to a growth of FDI.[8] In some cases it has negative aspect. Due to reciprocity of FDI flows the benefits offered by domestic taxpayers in another country should be compensated by the same advantages for foreign taxpayers in this country because both contracting states act towards the taxpayers as the state of tax residence as well as the state of source of income. FDI flows between developed and developing countries are asymmetric whereas developed countries are capital exporters in economic terms. If developing countries are parties to bilateral tax treaties based on the principle of taxation by the state of tax residence, it causes a loss of tax revenues for these states. It is clear that double tax conventions based on the OECD Model Convention are only suitable for regulation of relations between those states where capital flows are about the same. Despite or perhaps because of that, the most of double tax conventions are concluded on the basis of the OECD Model Convention.[9]

A significant lack of tax treaties is also fact that, during their implementation, limitations occur mainly due to differing interpretations of the provisions and inconsistent legal coverage of new cases which circumvent the purpose of the treaties. Administrative costs of negotiation and ratification of the treaties are obvious disadvantages of double tax conventions. The states have to synchronize the provisions of national tax laws, as well as other legislation, with the content of tax treaties.

Based on the above mentioned facts the objectives of the double tax conventions are to:

- avoid situations with international double taxation of income,
- establish cooperation of financial authorities of the contracting states in order to prevent international tax evasion. In this respect conventions contain provisions on mutual cooperation of the states, in particular on exchange of information,
- ensure fair distribution of tax revenues between contractual states,
- ensure legal security which is necessary to attract foreign investment,
- eliminate discrimination of foreign entities,
- facilitate the development of international trade relations and cross-border economic activities.

3. FUTURE OF DOUBLE TAX CONVENTIONS

The states conclude bilateral double tax conventions but also actively participate in multilateral cooperation at the Organization for Economic Co-operation and Development and the United Nations while drafting the provisions of the OECD Model Convention or the UN Model Convention. They are not legally binding and therefore it is a crucial reason why states can reach agreement on its content. Considering that the states are free to deviate from the provisions of model conventions in their bilateral negotiations. They are more willing to agree with wording of a model on international forums, even though it may not fully reflect their preferences and interests. Genuine flexibility of model conventions, as soft law institute, is one of the main reasons why states are inclined to such modifications. It can be said that the states negotiate general version of model conventions on multilateral level but they are not legally bound to follow them during negotiations with other states. The states negotiate specific provisions of double tax conventions at bilateral level.

According to some European experts on tax law, during a negotiation about tax treaties, member states of the European Union should follow the EU Model Tax Convention which they suggest.[10] It should be adopted by the Commission and it should have a similar structure to the OECD Model Convention with dominant principle of taxation by a state of tax residence but it should contain specific provisions reflecting special relationship in the European Union. The author does not see point of this model because all Member States of the European Union are members of the Organisation for Economic Co-operation and Development so they have sufficient influence on its provisions. According to a proposal the EU Model Tax Convention should be only recommendatory like the OECD Model Convention and that would not prevent to negotiate arbitrary treaties. Proposed changes in the provisions also would not solve the problems associated with current tax treaties between member states.

It can be stated that the system of double tax conventions which works at present between the countries has significantly contributed to solving the issue of international double taxation but fully elimination of this phenomenon has not occurred. There are still conflicting issues related to the application of contractual clauses, types of income or classification of economic entities, etc. The author believes that substantial limit of currently concluded tax treaties is their bilateral character. Because of the bilateral nature they can not effectively address the problem of double non-taxation arising out of tax competition of the states or triangular cases. The solution is seen in the adoption of multilateral conventions between the states which should, in current critical times, be willing to collaborate and to focus just on coordinated solutions. The states protect their tax revenues, eliminate tax discrimination, and resolve problems of double taxation or non-taxation only by adopting comprehensive conventions. According to the author, for full and effective achievement of the objectives, which the states face and which arise out of international legal tax relations, it is needed to adopt multilateral conventions. He further agrees that the states that are now part of the global economic market would be ideal for multilateral treaties dealing with whole complex tax issues and trade relations.[11] In this respect, the author realizes that even if the benefit of such conventions for further development of global trade and economic is undoubted, the implementation of such ideas is considered nowadays impossible.

The author deems that it is easier to accomplish creation of a multilateral double tax convention within the political-economic structures such as the European Union.[12] The Union is a tight integration group, consisting of the states with similar tax systems and the same objectives in taxation. Bilateral arrangements of tax relations between the Member States rather create distortions in internal market because tax treaties do not have identical content and do not provide the same tax rules for

[8] See more: BARTHEL, F. – BUSSE, M. – NEUMAYER, E. *The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data.* In: Contemporary Economic Policy, Vol. 28, No. 3, 2010, pp. 368-375.

[9] See: http://www.oecd.org/about/history/

[10] See: LANG, M./SCHUCH, J./URTZ, CH./ ZUGER, M. *Draft for a Multilateral Tax Treaty.* In LANG, M., LOUKOTA, H., RADLER, A., SCHUCH, J., TOIFL, G., URTZ, CH., WASSERMEYER, F., ZUGER, M. (eds.) Multilateral Tax Treaties. New Developments in International Tax Law. London: Kluwer Law International, 1998. pp. 197-245.

[11] See e.g. AVI-YONAH, R. – SLEMROD, J. *(How) Should Trade Agreements Deal with Income Tax Issues?* In: Tax Law Review, Vol. 55, No. 4, 2002, pp. 533-554.

[12] There is already an example of the multilateral treaty in the area of tax law: Convention on Mutual Administrative Assistance in Tax Matters drawn up within the framework of the Council of Europe and the OECD, which was signed at Strasbourg on 25 January 1988 and entered into force on 1 April 1995. Protocol amending the Convention on Mutual Administrative Assistance in Tax Matters entered into force on 1 June 2011.

all taxpayers. A multilateral tax treaty would make it possible to address the problems that are insoluble under the system of bilateral treaties and it would introduce greater legal security. An example would be the Nordic Tax Treaty which replaced previous bilateral treaties between the five countries.[13]

Despite these shortcomings it should be noted that double tax conventions are currently the most important and most effective ways to combat double taxation and tax evasion in international tax relations. Their importance is highlighted by other issues which govern the relations between the states, i.e. effort for fair distribution of tax revenues, creation of stable legal environment or prevention of discrimination of foreign persons. Solving these issues on a contract basis, contributes not only to the development of international trade relations between the states, but also to the expansion of international business opportunities and jobs.

It is difficult to predict future development of double tax conventions but the author does not expect any dramatic changes in the system of these tax treaties in close future. Activity of the OECD Committee on Fiscal Affairs and the UN Group of Experts continue permanently, while trying to modernize present model conventions and adjust them to current trends in international tax relations. Technical innovations resulting from bilateral tax treaties, as well as other innovations that are being developed in the framework of the activities of these committees are being implemented there. According to the author, it is likely that, within different integration structures, proposals for harmonization and unification of bilateral tax treaties between the Member States will be elaborated. That will lead to adoption of multilateral tax treaties. In addition to the European Union there are proposals for a multilateral tax treaty also within the Association of South East Asian Nations.[14]

CONCLUSION

At present, double tax conventions are inseparable part of international legal tax relations and the most important source of international tax law. Tax treaties complement tax systems of the states by laying down the methods for elimination of double taxation, the rules for taxation of certain incomes and exchange of information between competent authorities in the fight against tax evasion. Simultaneously, they also contain provisions to ensure legal security and non-discrimination of the persons which are essential for attracting foreign investment. This helps both to avoid international double taxation and prevent tax evasion, and also supports international trade between states and flow of foreign investment. In this respect, in the opinion of the author, double tax conventions concluded between the states on the basis of model conventions are regarded as a tool for harmonization of international tax relations.

The states conclude bilateral double tax conventions in order to maintain a space for promoting their economic interests which would not be sufficient in negotiations with several countries on multilateral tax treaties. For achievement of desired goal, i.e. prevention of loss of revenue from income tax because of double non-taxation, but also solution of other issues that stand before the states in international legal tax relations, greater co-operation in future will be needed. Double tax conventions will have to be subject to revision and will be replaced by another solution in political-economic structures such as the European Union or the Association of South East Asian Nations. Multilateral tax treaty will enable the states to achieve desired objectives associated with the development of a single market and support of economic growth.

[13] Multilateral Tax Agreement between Denmark, Finland, Iceland, Norway and Sweden, signed in Helsinki on 22 March 1983.
[14] See more: JOGARAJAN, S. *A Multilateral Tax Treaty for ASEAN – Lessons from the Andean, Caribbean, Nordic and South Asian Nations.* In: Asian Journal of Comparative Law, Vol. 6, Iss. 1, 2011, pp. 145-166.

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Primary Paper Section: A

Secondary Paper Section: AG