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Bilateral Treaties on Elimination of Double Taxation on Income and Capital and Prevention of Fiscal Evasion: Past, Present and Challenges *Pro Futuro*

Introduction.

Bilateral treaties on elimination of double taxation and prevention of fiscal evasion have a key role in the context of international tax cooperation. On one hand, these double tax treaties encourage international investment and global economic growth by eliminating or reducing the negative effects of international double taxation on income and capital gained as a result of cross-border activities of the entities. On the other hand, they improve the cooperation between tax authorities, primarily in order to achieve efficient combat against international tax evasion.

Developing countries, especially those least developed, are often faced with a lack of experts and practice that are necessary for effective interpretation and application of bilateral treaties on elimination of double taxation. Consequently, the inefficient use of the treaties and, moreover, insufficient experience of tax administration could jeopardize the country`s development and progress as an effective tax partner. As a result, there is an understandable necessity for improving the skills of the tax authorities in developing countries, that can further strengthen their role in improving the international investment climate and preventing international tax evasion.

In the last three decades, the number of signed and ratified bilateral treaties on elimination of double taxation worldwide has significantly increased. Nowadays, there are more than 20 different types of double tax treaties, including agreements on elimination of double taxation on income and capital, agreements on elimination of double taxation on inheritance and gift, bilateral agreements on administrative assistance in tax matters, etc. The main aim of this

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article is to analyze the role and importance of double tax treaties in terms of international tax law and to identify the key challenges for their future implementation.

1. Definition and Origins of Bilateral Treaties on Elimination of Double Taxation on Income and Capital.

Bilateral treaties on elimination of double taxation (more known as "double tax treaties" or "double tax agreements"; hereinafter bilateral tax treaties) *are agreements between two countries aimed to allocate the taxing right on income and capital among the contacting states in circumstances when both countries have the right to tax such income or capital.* This is usually determined by applying series of provisions that clarify the way the national tax rules of the contracting parties are applicable to certain types of income or certain taxpayer.

Most double tax treaties are comprehensive meaning that they cover all types of income and capital. However, there are some agreements that have a limited scope, such as the bilateral agreement between Australia and Greece which applies only to taxes on profits from air traffic. Some treaties, however, have expanded their scope, for example the bilateral agreement between the Great Britain and USA that includes specific excise duties or the agreement between Australia and New Zealand that covers the additional employees` cash and non-cash benefits. Generally, the structure of bilateral treaties on elimination of double taxation on income and capital is quite similar, but they often differ. Although two bilateral tax treaties may look identical, some provisions may vary in material terms. Therefore, we have to be careful with the assumption that same conclusions can be drawn for the implementation of different bilateral treaties on elimination of double taxation on income and capital[2].

The very first double tax treaty is the agreement on elimination of double taxation with respect to taxes on death signed in 1872 between Great Britain and the Swiss canton of Vaud. This agreement has a significant place in the history of international tax law, because, according to the League of Nations and the United Nations, it is the first bilateral agreement that is exclusively and directly related to the problem of double taxation, although to a limited extent. The treaty was signed through exchange of declarations by both countries, while its

[2] Lang, Michael, *Introduction to the Law of Double Taxation Conventions*, IBFD Publishing, Amsterdam, 2010, 5-11.

subject were the inheritance or succession charges in a case of death imposed by one state to nationals of the other state, i.e. the imposition of charges by Great Britain to nationals of the Canton of Vaud in case of their death in the UK and vice versa[3].

2. The Purpose of Bilateral Tax Treaties.

The need for bilateral tax treaties arises from the presence of conflicting taxation rules on same income and/or capital in two different tax jurisdictions. Due to the fact that there is no clear definition of the term "taxable income and/or capital", internationally accepted, the same kind of income and/or capital may be subject to tax in two countries. In this case, these two involved countries signed bilateral tax treaty, which incorporates the following possibilities:

(1) Income or capital shall be taxable only in one Contracting State;

(2) Income or capital will not be taxed in the both Contracting States;

(3) Income or capital may be taxed in both Contracting States, but the resident country will apply one of the methods for elimination of double taxation, tax credit method or exemption method[4].

The main purpose of bilateral tax treaties is the proper allocation of taxing rights between the two legitimately involved jurisdictions or allocating the right to tax to one of the contracting states. This purpose is also clearly defined in the OECD Model Tax Convention on Income and Capital, which states that "it is desirable to clarify, standardise and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation."

The purposes of the bilateral tax treaties can be summarized as following: first, they help to avoid and eliminate the negative effects of international double taxation by establishing allocation rules for taxation of the earned income and capital by the contracting states. Second, bilateral tax treaties provide greater legal certainty for taxpayers because, through these treaties, the taxpayers can properly determine their overall tax burden from cross-border

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[3] Jogarajan, Sunita, *The Conclusion and Termination of the First Double Taxation Treaty*, Law Journal, Melbourne Law School, Melbourne, 2008, 1-3.

[4] Ray, Sarbapriya, *A Close Look into Double Taxation Avoidance Agreements with India: Some Relevant Issues in International Taxation*, International Affairs and Global Strategy, Vol.2, 2011, 2-4.

activities[5]. Another benefit from bilateral tax treaties is the elimination of discrimination against foreign taxpayers or permanent establishments in the country of source vis-à-vis domestic taxpayers. These bilateral treaties are created in order to allocate the right to tax between the contracting states and to prevent tax avoidance and/or tax evasion. Finally, the bilateral tax treaties ensure fair and equal treatment of taxpayers who have different residency status, resolve differences in taxation of income and/or capital and exchange of information and other relevant details between the contracting states[6].

Additionally, bilateral tax treaties have at least four other important coordinative purposes. First, the contracting states adopt common definitions of relevant taxation facts, such as the definition of the term "permanent establishment". Second, most treaties have provisions regarding the mutual agreement, which is applicable in cases of disputed interpretation of the treaty. Third, in order to prevent abuse of bilateral tax treaties, the contracting states incorporate restrictions and rules, such as the general anti-abuse provision, which allow tax authorities to examine if one transaction is undertaken in order to avoid paying tax or not. And fourth, most tax treaties provide automatic exchange of information or exchange of information upon request as a measure against tax evasion, while some treaties, especially the ones prepared according the OECD Model Tax Convention on Income and on Capital, provide assistance in tax collection[7].

3. Functions, Objectives and Importance of Bilateral Tax Treaties.

Bilateral tax treaties are binding for the contracting states. They impose rights and obligations for the states and their residents. However, it should be emphasized that these bilateral treaties do not impose taxes; they only have the function of limiting the states` sovereign right to tax. In other words, bilateral tax treaties shall allocate the taxing rights between the two countries, while the country autonomously decides whether and to what extent will use the assigned taxing right.

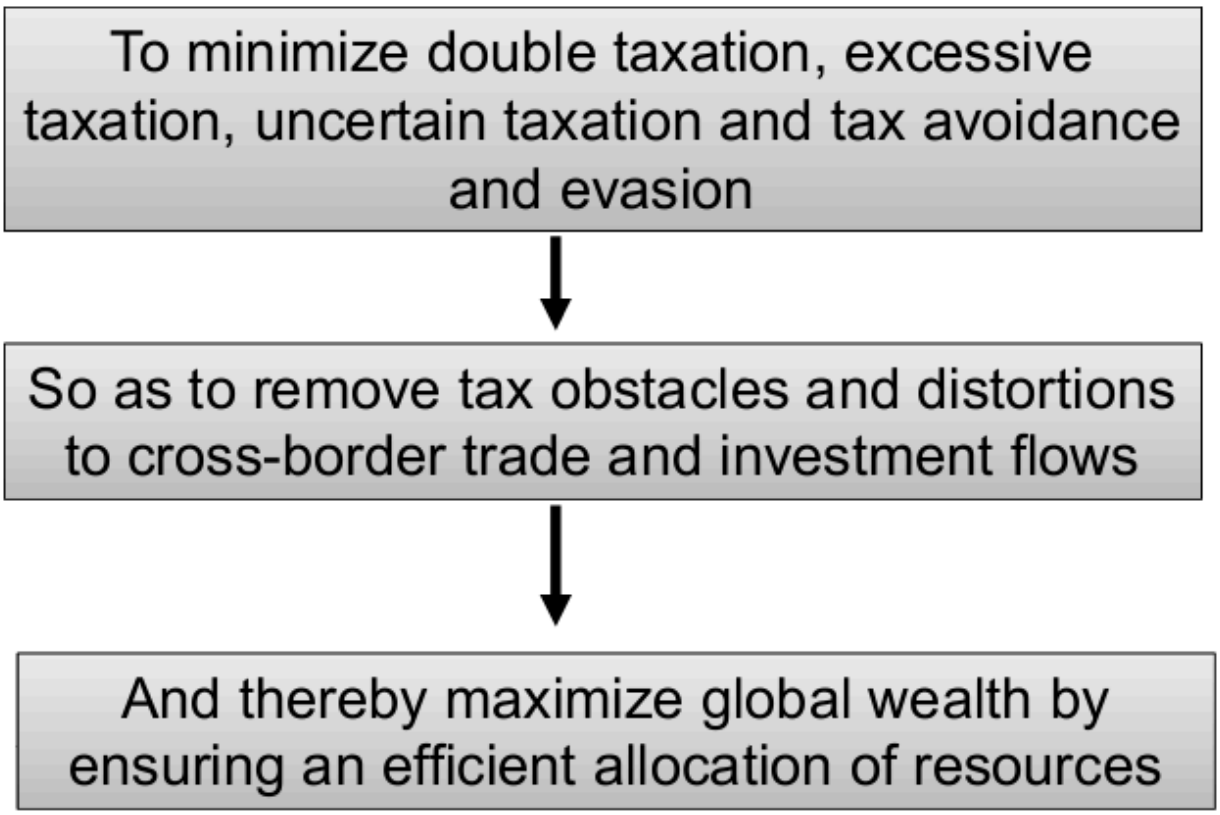
Bilateral tax treaties facilitate and encourage cross-border trade and international investment. This objective is achieved by elimination of double taxation on income and capital

[5] Lang, Michael, *Multilateral Tax Treaties: New Developments in International Tax Law*, Series on International Tax Law No.18, Kluwer Law International, Hague, 1998, 43-48.
[6] Vogel, Klaus, *International and Comparative Taxation*, Kluwer Law International, London, 2002, 69-78.
[7] Holmes, Kevin, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application*, IBFD Publications, 2007, 22-25.

earned abroad; prevention of fiscal evasion and international double non-taxation; investor`s protection from discriminatory treatment in the country of source; administrative cooperation between tax authorities of the contracting states and resolving contentious situations arising from the application and interpretation of bilateral treaties[8].

Figure 1 shows the objectives of the bilateral tax treaties. See Figure 1.

Figure 1: Objectives of Bilateral Tax Treaties



Source: Partington, David, *An Introduction to the Role and Structure of Tax Treaties,* OECD Publishing, 2011 5-8.

Bilateral tax treaties achieve these objectives through:

- elimination of the most common forms of legal and economic double taxation;

[8] Arnold, Brian, *China`s Tax Treaty Policy*, International Comparative Studies on Tax Reform, Part 2, 2000, 76-78.

- elimination or decrease of taxes that would otherwise be paid by foreign investors;
- elimination of some forms of tax discrimination;
- providing a set of standardized rules for allocation of taxing rights between contracting states;
- detection and prevention of tax avoidance and fiscal evasion;
- providing a framework for resolving tax disputes;
- providing a stable tax environment for foreign investors; and
- increasing the international competitiveness of the national economy.

Most countries consider bilateral tax treaties as a useful instrument of international tax law, because they enable free and secure cross-border activity of taxpayers, regardless they are individuals, partnerships or corporate entities. The functions of bilateral tax treaties can be identified as[9]:

a) *Distribution of taxing rights between the contracting states.* Bilateral tax treaties allocate the right to tax between the states. The taxing rights under the treaty only apply to residents of the contracting states and only in respect of taxes stated within the treaty. There may also be some type of income or capital which is not covered by the treaty and in such case, the treaty will not be applicable and that income will be taxed according the national tax laws. Once it is identified that the taxpayer is a resident of one or both contracting states and the tax is covered by the treaty, then the appropriate allocation rule is determinate.

b) *Elimination of international juridical (legal) double taxation.*

c) *Prevention of fiscal evasion.* The exchange of information and mutual agreement provisions in bilateral tax treaties enable states to obtain information in order to ensure that their taxing rights are preserved, although the efficiency of such provisions for fight against tax avoidance, which is opposite to tax evasion, are fairly limited at the moment.

d) *States which are parties to bilateral tax treaties.* Countries that have high tax rates have no interest to sign bilateral tax treaties with tax havens such as Bermuda, the British Virgin Islands, Anguilla, etc. However, some countries, such as Hong Kong, that apply the principle of source in taxation, have no reason to worry about international double taxation of their

[9] Saunders, Roy, *Understanding Double Tax Treaties*, Journal of International Trust and Corporate Planning, Vol.9, No.1, 2002, 1-4.

residents. Nevertheless, when their residents are actively involved in international activities, these countries are interested in signing bilateral tax treaties in order to allocate taxation rights and prevent fiscal evasion. Countries with low or zero tax rates may have such bilateral tax treaties, but in small numbers (for example Liechtenstein has concluded such treaty only with Austria), or most countries that negotiate with them attempt to introduce certain restrictions in the treaty (for example exclusion of offshore companies). Cyprus is one of the few countries that have been able to negotiate wide range of bilateral tax treaties without any restrictions, although they do exist in certain treaties (like the treaties that Cyprus has signed with the Great Britain and the USA).

The importance of bilateral tax treaties is determined from the government and taxpayers` viewpoint[10]. For tax authorities bilateral tax treaties have the following objectives and functions:

- elimination of double taxation in order to prevent discouragement of international trade and investment and free movement of persons;
- providing legal certainty for foreign investors and traders;
- ensuring cooperation between tax administrations in order to prevent and combat tax avoidance and tax evasion;
- ensuring exchange of information in order to prevent tax evasion and to enable right implementation of the treaty;
- elimination of certain forms of tax discrimination, and
- guaranteeing and providing mutual assistance in tax collection.

For the taxpayers bilateral tax treaties have the following objectives:

- provide some guarantees of the tax treatment in a foreign country;
- protection against international double taxation in most situations;
- provide tax exemptions or reduction of taxes.

Over the years, the realization of the two main objectives of bilateral tax treaties, elimination of international double taxation and prevention of fiscal evasion, was achieved with diverse progress[11]. The problem of double taxation is mostly solved, partly through domestic legislation and in part through the development of a network of bilateral tax treaties. However, one issue that still causes significant problems in the area of double taxation is the *arm`s length*

[10] Brincat, Caroline, *Principle of International Taxation*, IBFD Publications, Amsterdam, 2007, 12-20.
[11] McIntyre, Michael, *Legal Structure of Tax Treaties*, Wayne State University Law School, Michigan, 2010, 1-5.

principle, aimed at preventing the abuse of transfer pricing. Still, much less progress has been made in solving the problem of fiscal evasion. Multinational companies have become quite proficient in finding possibilities to evade taxation on income and/or capital from their cross-border activities. In certain aspects, bilateral tax treaties have increased the risks of fiscal evasion while failing to prevent the so-called *treaty shopping*[12].

4. Dynamics and Expansion of the Number of Bilateral Tax Treaties Worldwide.

The end of the Second World War marked the beginning of the expansion of the network of bilateral tax treaties. Mostly, the increase of number of bilateral tax treaties after the Second World War was a result of the USA program that recommended signing such treaties with other tax jurisdictions. On the other hand, the United Kingdom, soon after signing the bilateral tax treaty with the United States in 1945, encouraged its territories and colonies and some European states to sign bilateral tax treaties. In the period between World War II and 1950 UK signed 47 new bilateral tax treaties and, with total of 104 treaties, had the largest network of bilateral tax treaties in that period[13].

By some means the development of bilateral tax treaties in this period is related to the collapse of colonialism. Different to some countries, like Britain and the Netherlands that signed bilateral tax treaties with some of their colonies, the processes of decolonization and gaining independence were the reason for development of bilateral tax treaties between independent states. As a result, the success of bilateral tax treaties in this period was due to the fact that they mostly corresponded to the geopolitical conditions that prevailed between the end of empires and the emergence of trading blocs[14].

The complete world network of bilateral tax treaties includes more than 18,000 treaties. However, by the end of 2007, 2351 bilateral tax treaties are signed by OECD member states and they have covered a large part of world stocks and foreign direct investment flows.

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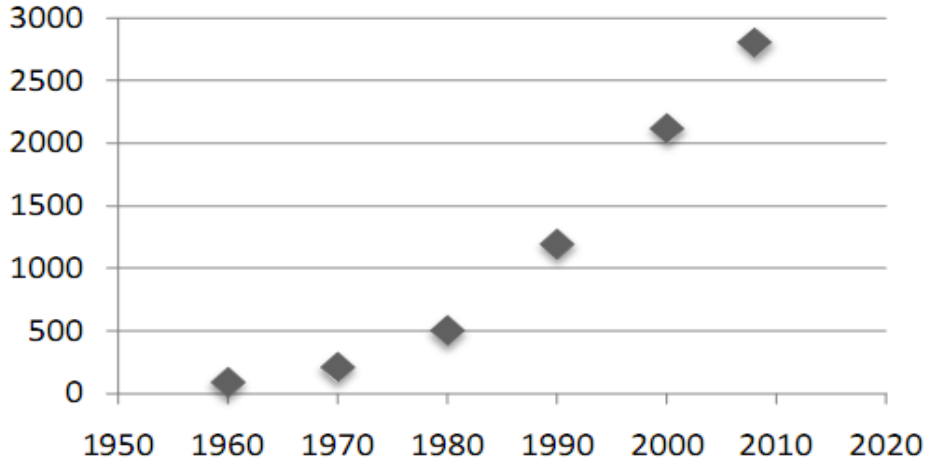
[12] Oeser, Bettina, Braunig, Christoph, *The History of German Double Tax Treaties*, Nationalbericht Deutschland, Munich, 1999, 40-48.

[13] Taylor, John, *Twilight of the Neanderthals, or are Bilateral Double Taxation Treaty Networks Sustainable?*, Melbourne University Law Review, Vol.34, 2001, 290-293.

[14] Latulippe, Lyne, *The Expansion of the Bilateral Tax Treaty Network in the 1990s: the OECD`s Role in International Tax Coordination*, Australian Tax Reform, No.27, 2012, 853-855.

74% of the total number of bilateral tax treaties has been signed by the developed countries, and 38% of the developed states` treaties are signed with developing countries, 24% with other developed country and 12% with states in transition. Bilateral tax treaties of developing countries represent 16% of total bilateral treaties into force; treaties of developing countries or transitional economies represent 8% of total treaties into force, and finally only 2% of total treaties are signed by the Commonwealth of the Independent States (including Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Turkmenistan, Uzbekistan and Ukraine) and South-East Europe[15]. The following Figure shows the number of ratified bilateral tax treaties worldwide from 1960 to 2008. See Figure 2.

Figure 2. Number of ratified bilateral tax treaties worldwide from 1960 to 2008

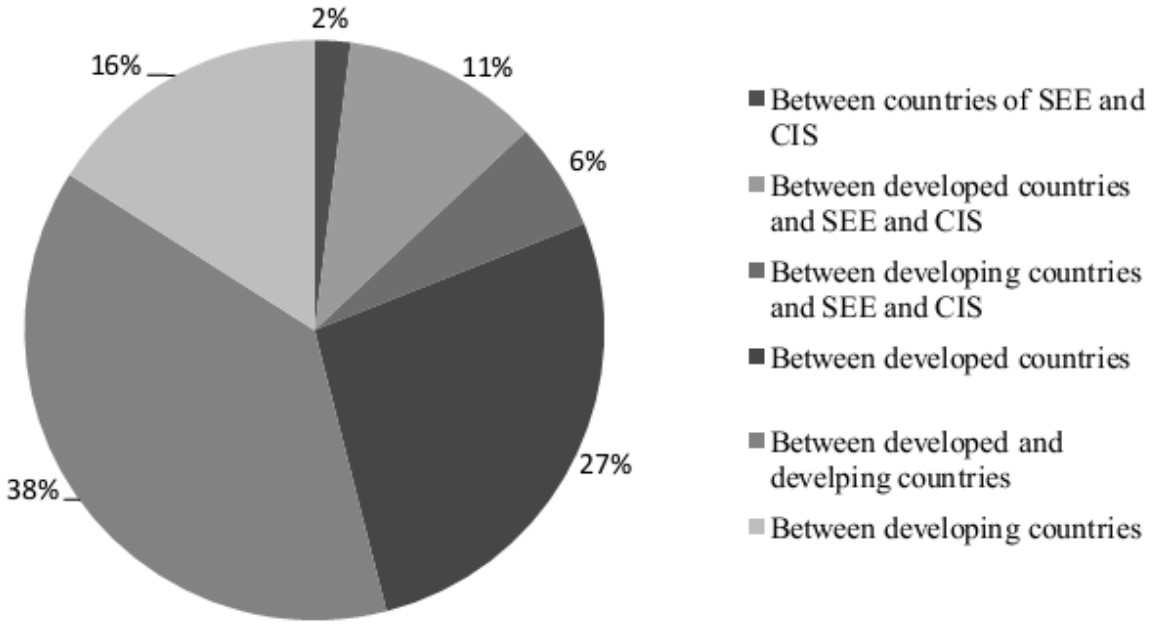


Source: Kuparadze, Giorgi, *Double Taxation treaties and Their Dynamics in The World Economy,* TSU CENTER For Social Science, 2013 3.

Additionally, the Figure 3 shows the ratified bilateral tax treaties signed between countries with different socio-political and economic structure. See Figure 3.

[15] Barthel, Fabian, Busse, Matthias, Neumayer, Eric, *The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data*, Contemporary Economic Policy, Vol. 28, No.3, Western Economic Association International, 2009, 368.

Figure 3. Ratified bilateral tax treaties between countries with different socio-political and economic structure



Source: Kuparadze, Giorgi, *Double Taxation treaties and Their Dynamics in The World Economy,* TSU CENTER For Social Science, 2013, 3.

The Figure 4 shows the 10 countries with the highest number of signed and ratified bilateral tax treaties by the end of 2006. See Figure 4.

Figure 4. 10 countries with the highest number of signed and ratified bilateral tax treaties

Source: Kuparadze, Giorgi, *Double Taxation treaties and Their Dynamics in The World Economy,* TSU CENTER For Social Science, 2013, 3.

And finally, the number of ratified bilateral tax treaties between the "old" and the "new" EU member states is 134 treaties. This network is not complete, since the total possible number is 150 bilateral tax treaties. The so-called "new" EU member states have signed 40 bilateral tax treaties between themselves of 45 possible. At the same time, the network of bilateral tax treaties between the so-called "old" EU member states is complete, 103 of 103 treaties. The final and total number of bilateral tax treaties at EU level, taking into consideration the Nordic Convention between Sweden, Denmark and Finland, is 298 treaties, and currently there are 277 signed and ratified bilateral tax treaties[16].

5. Challenges and Future of Bilateral Tax Treaties.

Despite the indisputable fact of the effectiveness of bilateral tax treaties, several development trends in recent years have raised the doubt about the sustainability of tax treaties in the future. Some current challenges result from[17]:

a) *e-commerce* - challenges for tax systems arising from e-commerce, are summarized by Pastukov who claims that "the Internet, as a mean of communication unlike any other tool, does not fit in the current international taxation regime. First, it enables enterprises to operate in any country without establishing permanent establishment. Second, the Internet enables companies to transfer their taxable activities worldwide at much lower costs and regardless of changes in the legal and economic environment. Thirdly, it complicates the allocation of income and expenses to one transaction. Fourth, the Internet causes difficulties when there is a need to make difference between "providing services" and "ownership transfer". And finally, it complicates the assessment and collection of taxes. Thus, e-commerce creates opportunities and incentives for companies to avoid paying taxes under the current international tax regime[18].";

b) *the emergence of new financial instruments* - some states strive to develop national tax rules for financial instruments that will reflect more their economic rather than formal characteristics or, at least, they strive to develop national rules that will neutralize cross-country

[16] European Commission TAXUD, *EC Law & Tax Treaties*, Taxation and Custom Union, 2005, 2.
[17] Jansen, Sjaak, *Fiscal sovereignty of the member states in internal market: Past Future*, Kluwer Law International, Hague, 2011, 312-322.
[18] Pastukhov, Oleksandr, *International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions*, Boston University Journal of Science & Technology Law, 2006, 310- 319.

differences in the tax treatment of certain and dependent rights and obligations. In this context, one of the problems that occur is how to allocate revenue, gained from new form of financial instruments, under the right provision in the existing bilateral tax treaties.

c) *tax competition* – it is evident that in terms of free movement of capital cross national borders, taxes play important role in making investment decision. This led to increased tax competition between countries and cutting or, in some cases, even removing the withholding taxes on the capital gains in bilateral tax treaties. When withholding taxes are not included in the bilateral tax treaties, their function as a mechanism for allocation of taxing rights, elimination of double taxation and prevention of fiscal evasion becomes problematic because both the resident country and the country of source can tax the same type of income or capital;

d) *EU Directives and interpretation of the EU Treaty by the European Court of Justice* - the fourth challenge for the sustainability of the network of bilateral tax treaties arises from the development of supranational organizations, particularly the European Union. If we assume that EU is a threat to double tax treaties` sustainability, then the network of these treaties is endangered by the instruments of positive integration (usually the Directives of the European Council) and instruments of negative integration, which require consistency between fiscal rules of the EU member states and EU law;

e) *transfer pricing issues*, and

f) *the lengthy time periods needed to modify an entire double taxation treaty network* - the last problem that challenges bilateral tax treaties` future is the relative slowness with which they react to changes in tax policy and economic conditions. This is a result of the nature of bilateral tax treaties. Each treaty has to be negotiated and renegotiated when amendments need to be introduced into the existing bilateral treaty in order to adjust the treaty with the current economic and political factors relevant to particular bilateral relations. Therefore, bilateral tax treaties can be characterized as follows: successful for a longer period of time, adaptable to the conditions and circumstances that prevailed at a particular time, but unable to respond quickly enough to changing circumstances.

It is expected that in near future the “tax arbitration” provision will be included in the upcoming bilateral tax treaties. We believe that this provision will be rarely used, which indicates that mutual agreement procedure works well because the parties have reached a mutual agreement without the need to apply the mandatory tax arbitration. Finally, we think that in

future bilateral tax treaties will be an important instrument to prevent and eliminate not only double taxation, but also double non-taxation.

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