Developing Countries and International Cooperation on Income Tax Matters: An Historical Review

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1. Early History

The strong movement towards globalization at the end of the 19th century led many countries to seek ways of cooperating to avoid impediments to cross-border trade and investment and to minimize opportunities for tax evasion. A primary mechanism for cooperation was the bilateral income tax treaty.

The earliest income tax treaties were adopted by Prussia around the start of the twentieth century. Its first treaty was with Austria, signed in 1899. Soon thereafter, it entered treaties with Bavaria, Saxony, and Baden, followed by treaties with Luxembourg and the city of Bale. Other continental governments soon followed the Prussian lead. Hungary and Austria concluded a treaty in 1909.

The development of tax treaties was largely stalled by the hostilities that engulfed much of the world in 1914. With the dramatic increase in tax rates that followed the First World War, many countries, especially in continental Europe, became interested in dealing with double taxation problems through the treaty mechanism. Germany took the lead after the war, signing a treaty with Czechoslovakia in 1921 and with Austria in 1922. In 1922, Italy convened a conference in Rome of the states emerging from the dissolution of the Austro-Hungarian Empire (Austria, Hungary, Poland, Romania, and the Kingdom of the Serbs, Croats, and Slovenes). The goal was to forge a multilateral agreement among the represented countries. The practical result was a bilateral tax treaty between Italy and Austria.

2. Developments up to 1946

Beginning in the early 1920s, the League of Nations began to play a leadership role in promoting international cooperation on direct taxes. It published the first internationally important model tax convention in 1928. That model was the culmination of work that had begun in 1920. The convention recognized the importance of some sharing of taxing power between the source country and the residence country. It did not attempt to limit the methods the Contracting States might use to prevent double taxation. Instead, it offered alternative means of achieving a reasonable sharing of tax revenues from cross-border activities.

The League of Nations model convention of 1928 was prepared by a group of government experts on double taxation and tax evasion. The initial group, formed in 1922, had seven members, all officials from European countries (Belgium,

Czechoslovakia, France, Great Britain, Italy, the Netherlands, and Switzerland). In 1925, the committee was expanded to include two more European representatives (Germany and Poland) and three additional representatives from outside Europe (Argentina, Japan, and Venezuela). Beginning in 1927, the United States, which was not a member of the League, participated on an informal basis. The expanded committee produced a report and draft convention in 1927, which was circulated to League members and some nonmember States. In 1928, the Secretary General of the League convened a meeting of government experts in Geneva, Switzerland, to consider the draft convention. That group of experts included the eleven who had drafted the report and members from 16 additional countries (Austria, Bulgaria, China, Danzig, Denmark, Estonia, Greece, Hungary, Irish Free State, Latvia, Norway, Romania, South Africa, Spain, Sweden, and the Union of Soviet Socialist Republics). Influence of the international business community appears to have been modest, although the International Chamber of Commerce played a consultative role from the early 1920s onward. The drafters of the convention relied in part on a 1923 League of Nations report on double taxation prepared by a group of four economists from Great Britain (Sir Josiah Stamp), Italy (Professor Einaudi), the Netherlands (Professor Bruins), and the United States (Professor Seligman).

The League's first model convention clearly embraced the twin goals of eliminating double taxation and also preventing undertaxation. The Report (p. 26) states:

> From the very outset, the Meeting of Government experts realized the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international co-operation should prevent certain income from escaping taxation altogether. *The most elementary and undisputed principles of fiscal justice, therefore, require that the experts should devise a scheme whereby all incomes would be taxed once, and once only.* (Emphasis added.)

The League's group of government experts proposed three alternative ways of taxing income from cross-border activities. All three plans used the concept of a "permanent establishment" (PE) that had appeared in the early Prussian treaties. Under the three plans, the income of an industrial, commercial or agricultural "undertaking" would be taxable in the countries where its permanent establishments are situated. (Model 1a, Art. 5; Model 1b, Art. 2B; Model 1c, Art. 3.) The models differ primarily in their treatment of income from moveable capital. The first model generally reserves the right to tax in the source country, whereas the other two models generally assign the right to tax to the residence country.

To prevent double taxation of business profits when an "undertaking" has a PE in more than one country, the three models included in the 1928 convention provide that each treaty partner would tax the income "produced in its territory." The term "undertaking" was undefined; it apparently has the same meaning as the term "enterprise," which is an undefined term found in modern tax treaties. In general, an enterprise is a group of corporations or other legal entities under common control and engaged in a common business.

The allocation of income among taxing jurisdictions under the 1928 convention was to be accomplished through consultation between the "competent administrations of the two Contracting State." Some form of formulary apportionment was an acceptable method for allocating the income between the countries where the PEs were located. The important point was that all of the income of an undertaking would be allocated to some PE. No exemption or other tax relief for an item of income would be given in one Contracting State without giving the other Contracting State the concomitant right to tax that item of income.

The drafters of the 1928 convention were favorably disposed towards the resolution of some tax conflicts by ceding full jurisdiction to tax to the state of residence. On a unilateral basis, some countries, including the United States, had resolved the difficult problems of source taxation of shipping companies by ceding source jurisdiction to the residence country on a reciprocal basis. This approach was unworkable in many countries because they did not attempt to tax the worldwide income of their residents. In addition, it was not an attractive option for countries that would lose revenue from the reciprocal arrangement, due to the lack of foreign activities of their residents. The model convention was written so that it would be compatible with this development without being dependent on it.

The 1928 convention addressed only a small subset of the international tax issues of importance to the taxation of cross-border activities. Recognizing the need for additional work, the League of Nations established in 1929 the Fiscal Committee. The Fiscal Committee engaged in activities before, during, and after World War II. It ceased operations after the war when the League was supplanted by the United Nations.

During the 1930s, much of the work of the League's Fiscal Committee was in developing rules and standards for allocating the income of industrial and commercial enterprises operating in more than one country. In 1933, it prepared a draft multilateral convention on the allocation of profits. That model convention was revised in 1935 but never formally adopted. The basic approach in that convention was to treat a permanent establishment as if it were a separate enterprise and to determine its income based on what has come to be called the arm's length standard. The goal was to allow countries to determine the income of a PE based on the local books of account, without reference to the books of the entire firm. Apportionment by formula was reserved as a last resort. This approach was a marked change from the 1928 model convention, which provided that all of the income of an "undertaking" be allocated among the countries where the enterprise or undertaking has a PE.

Work on a model convention continued during the war years. In 1940 and again in 1943, the League's Fiscal Committee convened a regional conference in Mexico City to revise the 1928 convention. The meeting included representatives from countries of the Western Hemisphere, both developed and developing (Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States, Uruguay, and Venezuela). The regional conference produced a draft model convention, popularly known as the Mexico Draft.

In general, the Mexico Draft took the position that the primary jurisdiction to tax income should be assigned to the source country — the position favored by the developing countries. In this respect, the Mexico Draft was a major refinement of the League's 1928 model convention. The basic structure of the 1928 convention, however, remained unchanged. The Mexico Draft clarified an ambiguity in the 1928 convention by providing that all of the business income derived in a country would be taxable there unless the activities were "isolated or occasional" and the enterprise earning the income did not have a PE in that country. A protocol to the convention provided rules for attributing income to a PE. These rules, in general, followed the Fiscal Committee's 1935 draft convention for the allocation of profits.

In 1946, the League's Fiscal Affairs Committee, with a full complement of members, met in London, England, to review the Mexico draft. A new draft, popularly referred to as the London Draft, was produced. The London draft was similar in some respects to the Mexico Draft in the treatment of business profits. It differed from the Mexico Draft, however, in requiring that an enterprise resident in one Contracting State have a PE in the other Contracting State for that latter State to tax the enterprise on any portion of its business profits. The London Draft also imposed significant limitations on the taxation of investment income in the source country, contrary to the position favored by the developing counties and adopted in the Mexico Draft. For example, the Mexico Draft provided that royalties paid for the right to use a patent or secret process would be taxable only in the State where the right is exploited. In contrast, the London Draft reserved the right to tax such royalties to the country of residence.

3. 1946 to 2002

The United Nations came into being on October 24, 1945, although the League of Nations continued for some short period thereafter. Various governments concerned with tax treaty issues made efforts to revitalize the work of the League of Nations on tax conventions. Although the United Nations took an active interest in that effort, leadership in developing a model treaty was seized by the Organisation for European Economic Cooperation (OEEC). The OEEC was created in 1948 in conjunction with the Marshall Plan for revitalizing the economies of Europe. It had 16 members, all European countries outside the Soviet block. In 1956, the OEEC created its Fiscal Committee and entrusted it with the task of working out a draft model bilateral tax convention. The OEEC became the Organisation for Economic Cooperation and Development (OECD) in 1960. Membership of the OECD was extended to the major industrial countries of the world. It now has 30 members. Only two of the most developed of the developing countries — Mexico and South Korea — are members of the OECD.

The OECD published its draft model treaty in 1963. That convention drew heavily from the League's London Draft, but included additional features that favored capital exporting countries over capital importing countries. In form, the 1963 draft recognized the importance of sharing of revenue between the source and residence countries. Its practical effect, however, was to erect substantial barriers to the exercise of source jurisdiction and to afford multinational firms with major opportunities for tax minimizing strategies through its emphasis on legal form over

economic substance. The 1963 draft was revised slightly over the next decade and a half. It was published in final form in 1977.

The OECD model was extremely effective in eliminating most of the common types of double taxation. It was not very effective, however, in eliminating international tax avoidance and evasion. Indeed, several core features of the OECD model have promoted international undertaxation. The OECD model provides for an exchange of information on tax matters between the Contracting States. The goal of the exchange-of-information article is to curtail tax avoidance and evasion. Unfortunately, the article allows countries to decline to provide information if they have adopted bank-secrecy laws or otherwise are disinclined to exchange information for policy reasons. As a result, the exchange of information clause has not been effective in most cases. However, it has been effective for a few countries, such as the United States and Canada, that have a long tradition of cooperation on tax matters.

One feature of the OECD model that promotes tax avoidance is the treatment of affiliated entities. Under the model, a member of a multi-national enterprise (MNE) group will not have a PE in a country solely because it conducts its business in that country through a related company. This rule has been read broadly to mean that the affiliate relationship is irrelevant in determining whether the affiliate is the PE of the MNE group (or some member thereof). As a result, the affiliate must be an agent of the group and must habitually make contracts on behalf of the group to be a PE of the group. Tax planners have no difficulty in ensuring that an affiliate is never the PE of the group unless they have some reason for wanting it to be a PE.

The affiliate rule permits what tax specialists refer to as "entity isolation." In general, the MNE group assigns to a separately incorporated affiliate all of the activities and property that the MNE group needs to conduct business in a particular country and that would constitute a PE. To the extent possible, assets and activities that are likely to generate substantial profits are not assigned to the affiliate. For example, valuable intangible property, such as patents and secret processes, would not be assigned to the affiliate. The intangible property is kept in an offshore affiliate, and the taxable entity is required to pay a substantial royalty to the offshore affiliate for the use of the intangible property in the source state. As a result of such techniques, the MNE group typically is able to restrict the profits taxable in the source country to some modest return on its physical assets located in that country.

Three additional features of the OECD model, in addition to the PE rule, support entity isolation. First, the OECD model generally requires the source state to allow a deduction for royalty payments to a foreign MNE unless the tax authorities can show that the payments constitute some type of sham transaction or are unreasonable in amount. Second, the OECD model convention prohibits the source state from imposing a withholding tax on the royalty payments. Third, the OECD model has no effective mechanism for preventing treaty shopping — the use of a treaty by a resident of some third country that is not a party to the treaty. Through treaty shopping, an MNE can move income ostensibly allocated for taxation in the residence country to a tax haven country, with the result that the income of the MNE

is not taxed either in the source state or the residence state. These three rules, in combination, permit extensive use of what tax specialists refer to as earnings stripping.

The problems with the OECD model described above have been well understood by tax experts for several decades. Nothing has been done to deal with these problems for two reasons. First, the OECD typically operates by consensus, and some members of the OECD have been prepared to prevent agreement on any model that would undercut their ability to attract capital, including capital from those avoiding tax in other countries. Second, the OECD has been a victim of its own success. An important goal of a model convention is to promote uniformity. The OECD model has been embraced by most developed countries, with relatively minor adaptations, and, with some more significant modifications, by much of the rest of the world. To change the model is to upset the uniformity that the model has achieved. Given the very long gestation period for implementing changes in a country's tax treaties, a change in the model would result in non-uniformity for a decade or more. As a result, the OECD has attempted, with some limited success, to deal with defects in its model through its Commentary. Changes in the Commentary have been effective in addressing certain types of issues, but core issues like entity isolation cannot be addressed effectively through the Commentary.

The widespread success of the OECD model in the 1970s provoked a reaction from developing countries. Those countries, being outside of the OECD, were excluded from effective participation in the design of the model. Under the League of Nations, the developed countries were the dominant force in designing a model convention. Only in the Mexico draft were the interests of the developing countries given high prominence. Still, the developing countries were represented in the process of approving model conventions. With the capture of the model treaty process by the OECD, the participation by developing countries ended. They were disenfranchised at a time when the number of developing countries was increasing markedly, due in large part to the collapse of colonialism in Africa and Asia after World War II.

The developing countries responded to the success of the OECD model convention by developing their own model convention under the auspices of the United Nations. The United Nations' involvement in the treaty process originated with a resolution of the Economic and Social Council, dated August 4, 1967. That resolution requested the Secretary-General to set up an *ad hoc* working group of tax experts and tax administrators who would represent the interests of both developed and developing countries and would represent different regions and tax systems. The *ad hoc* group would be asked to formulate guidelines and techniques for use in tax treaties between developed and developing countries. In 1968 the Secretary-General responded to the resolution by setting up the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries. The group was composed of tax officials and experts from twenty countries. In principle, these officials were to act in their individual capacity and not as representatives of their government.

In 1979, the United Nations published a *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*. The manual

had been prepared by the Group of Experts and the UN Secretariat. The following year, the United Nations published the *United Nations Model Double Taxation Convention between Developed and Developing Countries*. That publication included a model convention and Commentary, both of which had been prepared and approved by the Group of Experts. The UN model was based in substantial part on the OECD model, but it departed from the latter model on some key points. In particular, it modified the definition of a PE to allow some additional taxation of business income by the source country, and it provided that any reduction in a country's statutory withholding rates would by done through bilateral negotiations. No specific target withholding rates were established in the model. The obvious expectation was that treaties based on the UN model would include a positive withholding rate on royalties and that the withholding rates on dividends and interest generally would exceed the rates recommended in the OECD model.

In 1980, the membership of Ad Hoc Group, renamed the Ad Hoc Group of Experts on International Cooperation in Tax Matters, was increased from 20 to 25. The membership currently includes experts and tax administrators from 10 developed countries and 15 developing and transitional countries. The countries currently represented are: Argentina, Brazil, Burkina Faso, China, Côte d'Ivoire, Egypt, Finland, France, Germany, Ghana, India, Indonesia, Israel, Jamaica, Japan Mexico, Morocco, The Netherlands, Nigeria, Pakistan, Russian Federation, Spain, Switzerland, United Kingdom, and the United States. A representative of the Palestine Authority is invited to attend the meetings of the Group of Experts.

The UN model has been effective in influencing the content of bilateral tax treaties between developed and developing countries. In particular, virtually all of the treaties between developed and developing countries provide for a positive withholding rate on royalty income, and the modifications proposed in the PE article by the UN model have been adopted widely. The core of the UN model, however, is taken from the OECD model. As a result, the UN model permits companies to engage in entity isolation to minimize their exposure to taxation in the source country. The UN model does have a somewhat broader exchange-of-information article. Unfortunately, developing countries have had little success in obtaining information from the developed countries through that article.

Both the OECD model and the UN model were not modified during the 1980s to respond to the increased globalization of the world economy. The OECD finally began making some amendments to its model in the 1990s, and now publishes its model in loose-leaf form. The United Nations published a new model in 2001 — the first revision in two decades. These revisions made many useful changes, mostly of a technical nature. The revised models, however, have continued the emphasis on formalisms. For example, both model conventions continue to permit entity isolation by treating the corporations comprising a multinational enterprise as if they were independent entities, notwithstanding their economic integration in most cases.

Although the OECD and UN models have addressed the set of international tax issues identified by the League of Nations in the 1920s, they have not addressed

many important international tax issues that have emerged in the 1980s and thereafter. For example, neither model addresses cross-border mergers, aggressive tax avoidance schemes, treaty shopping, hybrid entities, overlapping controlled-foreign-corporation regimes, and global trading of financial instruments.

4. Current Developments

In recent years, the OECD has attempted to involve developing countries in its various activities relating to tax treaties and international taxation in general. It has invited representatives of developing countries as observers on some of its meetings, particularly with respect to e-commerce. It has also invited a selected group of developing countries to register objections to positions taken by the OECD in the Commentary to its model convention. This initiative seems unlikely to result in the developing countries influencing the core decisions made by the OECD on tax treaty matters or on any other matters of importance to the OECD member states.

The OECD, the International Monetary Fund, and the World Bank have jointly established what they call the International Tax Dialogue (ITD), The stated purpose of the ITD is to promote discussion among governments and international organizations on international tax matters. So far, it has served primarily as a clearing house for various tax documents generated by the sponsoring agencies. The United Nations is a cooperative member of the dialogue but does not appear to have become an active participant.

In November of 2004, the Economic and Social Council of the United Nations (ECOSOC) elevated the Ad Hoc Group of Experts on International Cooperation in Tax Matters to the status of a permanent UN Committee. ECOSOC also made provision for an expansion of the Secretariat staff serving the Expert Group. The ECOSOC resolution adopting this change made explicit reference to the Monterrey Consensus, adopted at the International Conference on Financing for Development, which called for the strengthening of international tax cooperation through enhanced dialogue among national tax authorities and also called for special attention to be given to the needs of developing countries and countries with economies in transition.

This change in status has the potential for greatly increasing the voice of the developing countries in international forums dealing with tax issues. The high promise will not be converted into a reality, however, without the active political support of the developing and transition countries and the good will of other international organizations. The first meeting of the revised committee will be held in Geneva in December of 2005.