PLATFORM FOR COLLABORATION ON TAX

Launch Workshop for The Toolkit on Tax Treaty Negotiations

Sixth Session:
Practical considerations for agreeing on a "fair" withholding tax limitation

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Why Have Tax Treaties (including withholding tax provisions)?

- **Historical perspective** – effort to remove barriers to cross-border activity
  - Source-residence paradigm (including the PE threshold) reflected the realities of doing business for most of the last century
- **Countries use tax treaties for several purposes**
  - Reduce or eliminate double taxation (or excessive taxation)
  - Mechanism for information exchanges, dispute resolution and assistance in collection
  - Instrument to further economic policy
- **Countries differ** in both the importance they assign to different objectives and their preferences of how to address them

Common Academic Position: Developing Countries Should Hesitate Before Entering into Tax Treaties with Developed Countries

- **General utility of tax treaties**
  - Limited usefulness, as can achieve many of the objectives through unilateral actions (Owens 1963; Easson 2000; Dagan 2000)
- **Treaties result in a transfer of tax revenues** from source-based developing countries to residence-based developed countries
  - Developing countries give up tax revenue without any increase in foreign investment (Dagan 2000; 2018; Brooks & Krever 2015)
  - Zero or low withholding rates on dividends, interest, and royalties result in revenue transfers from developing countries to developed countries
- **Concerns that tax treaties facilitate aggressive tax avoidance strategies**

Observations

- **Anti-tax treaty position rests on questionable narrative**
  - Tax treaties transfer taxing rights from developing to developed countries
  - But, for a variety of reasons, the transfer of taxing rights results in little additional revenue for developed countries

- In determining desirability of tax treaties (including the withholding tax provisions), it is useful to view them as partly or largely as tax incentives rather than agreements on how to divide tax revenues

- Determining desirability of tax treaties (and individual treaty provisions) requires making country-specific and treaty-specific determinations of costs and benefits

Revenue Transfers Resulting from Tax Treaties between Developed and Developing Countries

- **Alternative One**
  - Tax revenues are transferred from developing countries to developed countries with little or no economic gain (developing countries get nothing for something)
  - Zero-sum game with aggregate tax liability to investor unchanged

- **Alternative Two**
  - Tax revenues yielded by developing countries are largely picked up by foreign investors with little or no tax collected by developed countries
  - In recent years, developed countries have generally been neither interested nor successful in taxing most foreign source income of their resident MNEs and use tax treaties to assist their MNEs in reducing their foreign tax liability

Treaty Myths

- **Treaty Myth Number 1**
  - Tax treaties are essential to reduce or eliminate double taxation (Dagan 2000; 2018)

- **Treaty Myth Number 2**
  - The primary purpose of tax treaties is to allocate taxing rights and revenue between countries with competing claims (Zolt, today)
    - For developing countries, treaties are primarily a device to encourage foreign investment
    - For developed countries, treaties are often used to assist resident MNEs in reducing their foreign tax liability

Tax Treaties as Tax Incentives

- Treating tax treaties as partly or largely tax incentive changes the focus to their utility in encouraging foreign investment from whether treaties are a fair allocation of taxing rights

- Question becomes whether tax treaties are the best instrument to achieve economic objectives
  - Are the economic benefits of tax treaties (lower withholding rates) greater than economic costs?
  - Are treaties the best tool to achieve economic objectives or are other types of tax incentives (tax holidays, reduced corporate tax rates) or other government action more effective?

Articles 10, 11, 12 and 12A: Withholding Taxes

- While often lumped together, withholding taxes are four (or more) very different animals

  Dividends: Inter-corporate dividends and portfolio dividends

  Interest: Related party interest and unrelated party interest

  Royalties: Related party royalties and unrelated party royalties

  Technical Services: Payments to non-resident service providers

- Potential differences that may influence policy choices

  Revenue and economic consequences (including incidence considerations)

  Treatment under domestic law

  Protecting the tax base

    Base erosion potential

    Minimum tax on business activity (for example, withholding tax where low level of corporate tax paid by distributing corporation or where business activity related to royalties where no PE)

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Argentine Tax Treaty Policy

Article 10.2 (Dividends) & Article 13.5 (Capital gains on shares)

a) Major holdings (25% or more of the capital): 10% withholding rate
b) Minor holdings (less than 25% of the capital): 15% withholding rate

*In some DTAs, 5% withholding tax where the B.O. is the other Contracting State (Sovereign Wealth Funds)

Argentine Tax Treaty Policy

Article 11.2 (Interest)

General 12% withholding tax rate.

*Some DTAs provide for a 0% withholding tax where:

a) the B.O. is the other Contracting State (Sovereign Wealth Funds);

b) the debtor is the Contracting State itself;

c) the loan is made, guaranteed or insured by the other Contracting State ;

d) the indebtedness arises as a consequence of the sale on credit of industrial, commercial or scientific equipment;

e) the loan is granted by a bank to an unrelated party at preferential rates and which is repayable over a period of not less than five years

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Argentine Tax Treaty Policy

Article 12.2 (Royalties)

General 10% withholding tax rate.

*Most DTAs provide for the following structure with different withholding tax rates:

a) Payments for the use or the right to use International News: **3%**;

b) Payments for the use or the right to use copyright on any literary, artistic or scientific work (if the B.O. is the author): **5%**

c) Payments for any other royalties: **10%**

d) Unregistered contracts for the transfer of technology / copyright paid to a person other than the author: **15%**

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Tax Treaty Policy

Dividends

- ✓ Integration system or taxation on the distribution at the shareholder level.
- ✓ This will depend on the need to establish a withholding tax or not;
- ✓ Determine if only one tax rate for tax administration purposes, or two rates to encourage majority investments
- ✓ The branch tax must be included in the treaty when such tax is contained in internal law.

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Tax Treaty Policy

Capital gains.

- There are countries without taxes at the disposal of shares; others on the opposite site, levy taxes not only on direct sales but also on indirect sales;
- Control problems to detect indirect disposals; support tools: independent auditor opinions on financial statements to determine taxes owed, public information; information exchange,
- Countries have changed fiscal policy over time due to the information obtained from audits; lack of application of anti-abuse regulations. Different criteria for taxing at source
- Sale of 25% stake with the application of the withholding rate provided for in the internal law
- Sale of any number of shares with stakes greater than 25% with application of the withholding rate contained in the internal law
- Reduced global rate of 10% with certain exempt entities (pension funds, financial institutions, shares sold on stock exchanges)

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Tax Treaty Policy

Article 11 (Interest)

- Some countries have adopted different withholding rates depending on the economic moment.
- Times of crisis in the 90s forced to negotiate reduced withholding rates to lower the price of the inflow of capital in loans.
- The most common rate was 4.9% applicable to financial entities and placement of bond debt.
- The debt market adjusted to these low rates; financial agents pressured to maintain them in that level.
- Once the crisis was over, higher rates were set; in renegotiations they went down again
- Other countries have set a fixed policy of a single rate of 10%

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Tax Treaty Policy

Article 12. (Royalties)

- Some countries have maintained the fixed policy of having a single withholding rate in their treaties, (10%) since it has proven to be reasonable to collect revenue from these payments.
- It does not affect the development of the activities to which these goods and rights are used, as a manufacturing industry in all its areas, from ordinary to specialized;
- Having maintained consistent rates led IP bidders to compete on price, with the withholding being a neutral element.
- Other countries have taken the position of wanting to attract intellectual property through a policy of reduced royalty rates.

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MANY THANKS

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What is Purpose of the Tax Treaty?

- Reasons for entering into the treaty (see A.1. of the Toolkit)
- Avoidance of double taxation
- Addressing excessive taxation and certainty
- Enhanced co-operation between countries

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The Risk of "Excessive" Taxation

- 'Excessive'? Subjective
- Policy considerations are not uniform
- Taxation on a gross basis more likely to lead to excessive taxation

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Balancing Desire for Investment with Lost Tax Revenue

Promoting cross-border activity

vs.

Tax revenue?

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Certainty is a Key Benefit

- Predictability and stability (plus dispute resolution)
- Avoiding excessive taxation and certainty; different conclusions for ‘fair’ taxation?

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Relevance of Other Tax Treaties

- Fairness in light of a country's other tax treaties
- 'Our preferences are better reflected in a treaty you already have; why is that approach not available to us?'

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Additional Factors

- Overall burden of taxation
- Persuasiveness of policy justifications
- Balance of the treaty
- Practical considerations

- Mutually beneficial outcome
- Flexibility, innovation and commitment to compromise...

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MANY THANKS

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