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Focus on Double Taxation Agreements

by Karl Wolfgang Menck, Hamburg

Anti-double taxation agreements between industrial and developing countries were on the agenda in Amsterdam shortly before the end of 1968. Representatives from Argentina, Chile, Ghana, India, Pakistan, the Philippines, the Sudan, Tunisia and Turkey guarded the interests of the developing countries of whom there were by then 112. Regrettably, only a few had followed the invitation to Amsterdam even though questions of far-reaching importance, also for developing countries, were to be discussed. Among industrial countries the leading contributors to development aid were all represented.

Multilateral Talks

It was not a mere coincidence that the meeting took place at the close of the first development decade. According to the Pearson Report¹, it ended in an atmosphere of disillusionment. The "frustration of development policy" was a term bandied around.

The need for a new strategy had long been undisputed. It was therefore regrettable that the meeting had not taken place before. It had after all transpired much earlier that the OECD draft for double taxation agreements between industrial countries was not suitable for developing countries. For the arrangements suggested in this draft presume that economic relations of a like kind exist between the two countries concerned. Inequitable burdens are bound to fall on the developing countries because these proposals provide for incomes arising in developing countries to be taxed in the industrial country. This way of avoiding double taxation deprives the developing country of important sources of taxation. That is the decisive drawback of arrangements in accordance with the OECD draft since

the taxation potential of the developing countries does not come up to that of industrial countries².

Necessary Changes Deferred

The recommendation that incomes arising in developing countries should be taxed in these countries and be exempted from liability to taxation in the industrial countries³ has therefore been welcomed by the developing countries. The misgivings registered by the industrial countries that earnings from foreign capital would have to carry an excessive burden are out of place. In their own interest, if for no other reason, the developing countries cannot charge higher taxes than apply in the industrial countries, for exports of capital would otherwise cease in view of its lower post-taxation profitability. Such an outcome would not suit the countries of the Third World. The developing countries would be given more leeway if taxes paid in them were recognised for relief against the total tax indebtedness for domestic and foreign operations in the industrial countries. If that were done, the burden would fall on the treasury of the industrial country in the form of larger revenue losses on sums allowed for relief⁴. As long as there is no limit to the tax which can be allowed for, the fiscal interests of the developing country, for instance that of obtaining as much tax revenue as possible, will be secured almost completely without capital imports by means of direct investment being cut down for tax reasons.

Understandably, the developing countries have come out in favour of such an arrangement, whereas the industrial countries want to set at

¹ Partners in Development, Report of the Commission on International Development. New York, Washington, London 1969, p. 3 ff.

² W. Mersmann, Internationale Doppelbesteuerung, in: Handbuch der Finanzwissenschaft, 4th vol., second completely revised edition, Tübingen 1965, p. 121.

³ UN, Tax Treaties between Developed and Developing Countries, New York 1969, p. 10.

⁴ UN, Tax Treaties, *ibid.*, p. 41/42.

least upper limits for the sums to be taken into account. Many double taxation agreements between developing and industrial countries exemplify the compromises possible in this respect. They also bear in mind that the investor, and not the fiscal authorities in the industrial countries, should benefit from the system of tax allowances and all tax reductions in developing countries⁵.

This purpose is met by an arrangement to the effect that not only the taxes actually paid are to be taken into account but those liable to tax may claim a refund for taxes which would have been payable had there been no tax easement. There are also composite arrangements which are, basically, intended only to ensure adjustments between the treaty countries. In Amsterdam the industrial countries took little notice of these. Instead they insisted on the autonomous character of their tax sovereignty, ignoring the fact that capital exports always and necessarily cut across rights of sovereignty.

Debate about Demarcation

As regards the demarcation of interest and dividends for liability to tax, the limited allowances procedure has gained general acceptance. The taxing power has however been conceded to the developing countries only for investments which have been integrated into the economy of the host country in the same way as indigenous enterprises. This stipulation necessitates complicated objective criteria for precise procedures. On the other side there are the methods of demarcation commonly practised under current agreements which refer only to terms of time. These alone determine at what date an economic unit has been integrated into the host country so

far that the tax liability must be ceded. The crudest, technically simplest and safest criterion is thus being applied. False inferences are however sometimes unavoidable. Long-term commercial transactions also benefit from the six months' time limit set⁶.

The recommendations of the experts who met in Amsterdam provide better demarcation lines. They do more justice to the involvement of foreign enterprises with the economy of the host country. In actual fact however nothing has changed yet nor can a date for the implementation of the proposals be forecast. A warning should however be uttered now already against undue expectations on the part of the developing countries.

For foreign enterprises are as a rule less closely integrated in an economy than is commonly assumed. This applies particularly to projects in the framework of the various industrialisation programmes. The industries established under these frequently form oases unconnected with local industry. Tax policy measures which put a burden on foreign direct investment, treating it as an inexhaustible "milk cow", cannot be forced through by double taxation agreements. They would go beyond the boundaries which equity demands should be conceded to developing countries.

Open Issues

There is at present little evidence of such designs in the developing countries. The double taxation agreements concluded show that developing and industrial countries have had similar ideas. Without them it would be impossible to reach any agreement. There are always some problems which must be treated separately. In

⁵ UN, Tax Treaties, *ibid.*, p. 42.

⁶ UN, Tax Treaties, *ibid.*, p. 12.

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this respect even the meeting in Amsterdam could not contribute any solutions.

The attribution of profits and costs to individual enterprises in the various countries, for instance, is still under dispute. The OECD proposed as a guideline a solution which was technically easy but in substance not quite unobjectionable. Costs and earnings are to be attributed to individual enterprises only insofar as they can be drawn upon for taxation⁷. A wide scope is thus left for arbitrary acts by individual countries which, especially in view of the supposed political and/or economic risks in the developing countries, cannot encourage exports of capital to the Third World. The banning on foreign currency grounds of the repatriation of profits—an important consideration in any decision about direct investments—leads to deliberate evasion by the charging of fictitious prices for supplies to subsidiaries in developing countries⁸. The tax offices in the industrial countries will find no fault with such manipulations which, after all, increase their revenue.

A problem of a very similar kind was completely excluded in Amsterdam, namely, what rate of interest for loans and credits from their parent company in an industrial country was to be allowed to subsidiaries in developing countries for calculating their tax liability.

Basic Questions under Dispute

The same thing happened with regard to compensation for losses, a subject which has not found its way into the law on foreign taxation and double taxation agreements although it is covered by internal State regulations⁹. By being placed under foreign economic and tax law, an enterprise is excluded from the close relationship which is presumed to exist economically, and thus also taxation-wise, in the case of domestic undertakings.

Abuses would be encouraged particularly by the different regulations for the keeping of books and procedures for the calculation of profits. Tax losses can, for instance, be manipulated in a developing country, with more tax advantages accruing consequentially in another country. The facilities for checking and auditing in developing countries are inferior to those in the industrial countries. Industrial countries are therefore inclined to suspect collusion between business firms and tax authorities in developing countries to the detriment of their own treasuries.

⁷ Die Vermeidung der Doppelbesteuerung, 3. Bericht des OECD-Steuer Ausschusses, Berlin/Herne 1961, p. 32 ff.

⁸ H. Kopmann, Die Steuerpolitik der internationalen Unternehmung, Düsseldorf 1969, p. 148 ff.

⁹ UN, Tax Treaties, *ibid.*, p. 24.

The loss of tax revenue entailed however would affect not only the industrial country but the developing country as well, which shows how little justification there is for such fears. Ministers of Finance however are still ready to listen to suggestions on how to eliminate unjustified benefits.

The sole justification for such apprehensions is in the context of the efficiency of development policy¹⁰. Disputes do not however as a rule arise because of this aspect but because the benefit passes indirectly to the industrial country. The „compensation for losses“ issue thus presents itself in another context: Are the investors at their place of residence to be subjected to equal charges for equal incomes irrespective of the place of origin or only the incomes in the country of origin irrespective of who are the recipients¹¹? Decisions on such questions however have only to do with the issue of equity in taxation. No less important are the effects on the raising of revenue. They are the cause of the failure to arrive at arrangements for the treatment of fictitious taxes in a developing country¹².

Far-reaching Differences still Exist

It will be seen clearly how little readiness there has been hitherto on the part of industrial and developing countries to harmonise their tax measures for the furtherance of the economy. All double-taxation agreements involve an adjustment between divergent interests, which does not of course mean that a different compromise might not be better. The protection of tax sovereignty is after all not the only consideration.

That is the declared objective also of the developing countries. They are however entitled to priority as far as tax revenue is concerned because there is a danger of the industrial countries unintentionally restricting the field of application of the agreements: the loss of tax sources is as a rule counterbalanced in the countries of the Third World by raising the rates of indirect taxes¹³. The latter are outside the scope of any bilateral arrangement, and resort to them threatens to reinforce the often-mentioned arbitrariness of tax impositions in the developing countries.

A way out of this vicious circle can be found only by joint efforts. Future anti-double taxation agreements with developing countries will be measured by this yardstick.

¹⁰ UN, Tax Treaties, *ibid.*, p. 22.

¹¹ UN Tax Treaties, *ibid.*, p. 22/23.

¹² UN, Tax Treaties, *ibid.*, p. 109.

¹³ H. H. Hinrichs, A General Theory of Tax Structure Change during Economic Development, Cambridge 1966.