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DRAFT MANUAL FOR THE NEGOTIATION
OF BILATERAL TAX TREATIES BETWEEN
DEVELOPED AND DEVELOPING COUNTRIES
INTRODUCTION

1. This Manual provides a detailed introduction to the issues addressed in the United Nations Model Double Taxation Convention between Developed and Developing Countries ("UN Model Convention") as revised in 2001. The goal of the Manual is to assist developing countries and economies in transition to negotiate tax treaties among themselves and with developed countries. The first edition of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries was published in 1979.

2. The Manual as revised consists of three parts. Part One contains an analytical and historical overview of international double taxation and tax avoidance and evasion. Part Two contains the articles of the UN Model Convention and a brief commentary thereon. Part Three contains suggestions relating to procedural aspects of tax treaty negotiations and to the application of provisions of the UN Model Convention. The Annex to the Manual reproduces the texts of the following model treaties: (1) Model Bilateral Convention for the Prevention of the Double Taxation of Income (Mexico Draft, 1943); (2) the Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property (London Draft, 1946); (3) the Model Convention for the Avoidance of Double Taxation Between Member Countries and Other Countries Outside the Andean Sub-region (Andean Model); (4) the Convention on Mutual Administrative Assistance in Tax Matters (OECD and Council of Europe, 1988); and (5) the OECD Model Convention on Income and on Capital (OECD Model, 2000).

3. The principal goals of a bilateral tax treaty\(^1\) are firstly, to encourage economic growth by mitigating international double taxation and other barriers to cross-border trade and investment and secondly, to improve tax administration in the two Contracting States by reducing opportunities for international tax evasion. Every country, developed or developing, embraces these goals.

4. Economic development is a high priority in most developing countries. Many developing countries seek to achieve greater levels of development by participating fully in the global economy. That is, they have opened their borders to a free flow of trade and investment capital. For that strategy to succeed, developing countries must be able to attract foreign capital. A

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\(^1\) The terms "treaty" or "convention" are used in this Manual interchangeably. See Vienna Convention on the Law of Treaties of 23 May 1969, art. 2(1)(a): "treaty" means an international agreement concluded between States in written form and governed by international law...whatever its particular designation." The formal name of a tax treaty typically is "Convention" or "Agreement."
bilateral tax treaty can make a developing country a more attractive investment location by removing tax barriers to investment, including international double taxation. In addition, a bilateral tax treaty can provide a venue for resolving tax disputes, and can reduce uncertainties about the tax regime the investor will confront. In some cases, a tax treaty can provide a positive tax incentive for investment in a developing country by residents of a developed country.

5. International tax evasion undermines a country’s tax policy by preventing that policy from being implemented. If taxpayers learn that they can successfully evade taxes with impunity, they are far less likely to conform their conduct to the requirements of the tax laws. All countries encounter serious problems in collecting the proper income tax on profits derived outside their borders. Those problems tend to be particularly acute in developing countries, however, because their tax administrations frequently are ill equipped to monitor foreign transactions. In addition, the consequences of international tax evasion can be acute in a developing country because that evasion is often accompanied by a loss of badly needed investment capital and foreign exchange reserves. Bilateral tax treaties help reduce the risk of international tax evasion by providing a framework for cooperation between the tax authorities of the Contracting States.

6. In the not-too-distant past, many developing countries were reluctant to embrace globalization and the market economy that drives it. They recognized that globalization, in principle, should lead to greater national and world wide wealth. They also recognized, however, that globalization has important social, political, environmental, and cultural implications, some of which they were not prepared to accept. They also feared that their economies were too weak to compete effectively in world markets. These fears were not groundless. Three events have pushed many developing countries towards globalization notwithstanding these fears. First, a number of developing countries that had joined the world economy were experiencing high levels of sustainable growth as a result that other developing countries wished to emulate. Second, the economic performance of many developing countries that had eschewed the market was disappointing. Third, the dynamism of globalization was such that developing countries were being buffeted by market forces whatever their chosen development model. The United Nations Millennium Declaration observes that "...the central challenge we face today is to ensure that globalization becomes a positive force for all the world’s people...only through broad and sustained efforts to create a shared future, based upon our common humanity in all its diversity, can globalization be made fully inclusive and equitable."

7. The desirability of promoting greater inflows of foreign investment to developing countries and economies in transition has been affirmed frequently in resolutions of the General Assembly and the Economic and Social Council. Foreign private capital flows and investment can play an important complementary role in the economic development process, particularly through the transfer of resources, managerial and administrative expertise and technology to developing countries, the expansion of productive capacity and employment in these countries, and the

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establishment of export markets. External private capital can play an important role in complementing domestic resources. For developing countries and economies in transition as a group, official inflows declined significantly in the 1990s and low income countries still rely largely on official flows for their external financing. The geographical distribution of foreign direct investment (FDI) inflows to developing countries shows that the flows of private capital are still concentrated in a small number of countries. For example, in 1998, five countries received 55 per cent of all the inflows to developing countries while less than one per cent of this total was shared by the 48 least developed countries. The major recipient countries are mostly middle income countries in Asia and Latin America which have adopted outward looking strategies and sound macroeconomic policies. In order to attract long term international investment flows, developing countries and economies in transition will have to take steps to put into place a transparent, stable and predictable framework for private investment and the institutional infrastructure that allows its efficient implementation. Such a framework and the related infrastructure encourages not only intentional but also domestic investment.

**Globalization and international taxation**

8. The process of globalization has been going on intermittently for centuries. By the start of the twentieth century, the major industrial countries had achieved a high level of economic integration. The process of global economic integration decelerated sharply after World War I, with many developed countries erecting high tariff barriers to international trade. The worldwide devastation of the means of production resulting from World War II further decreased opportunities for international trade and investment. In the aftermath of that War, however, many countries began cooperative efforts to revive and extend international trade and investment. The recovery began slowly in the 1950s and accelerated in the 1960s. By the 1990s, the integration of national economies into a global economy had far exceeded the levels obtained before World War I. Globalization had become an economic reality with which all countries had to contend.

9. As long as national governments are careful to prevent anti-competitive practices, such as monopolies, from developing, the process of globalization can generate a worldwide increase in living standards. The process of globalization, however, also tends to exacerbate inequalities in the distribution of income. The trend towards inequality can be countered, at least in principle, through progressive taxation. The power of the national governments to impose progressive taxes is reduced, however, by the process of globalization, for that process tends to weaken government control of its borders, and that control is what gives national governments the economic power to redistribute income among its residents. For the globalization of markets to increase worldwide welfare, therefore, governments are obliged to cooperate among themselves on income tax policies so as to maintain their ability to promote a fair distribution of the fruits of development. One important form of that desirable cooperation is an international income tax treaty.

10. The rapid increase in electronic commerce illustrates the need for cooperation among governments on tax matters. E-commerce takes place across national borders without the usual
border checks that accompany traditional commerce. A residence country, acting alone, may not be able effectively to tax income derived from e-commerce, partly due to lack of information on what has occurred at the source country and partly from the ease with which profits from many forms of e-commerce can be shifted to tax haven jurisdictions. The source country may also have difficulty in taxing e-commerce income, partly from administrative difficulties and partly from the tendency of income taxes imposed at source to operate as excise taxes on the purchaser. Acting in concert, however, residence countries and source countries should be able to develop viable approaches to the taxation of e-commerce.

11. Many multinational enterprises (MNEs) undertake integrated production activities in several countries. Where they place a particular operation often is based on business considerations unrelated to taxation. In some cases, however, the MNE may determine that it can satisfy its business requirements in more than one country. In such cases, it is likely to attempt to reduce the aggregate tax liability of its corporate group by locating operations in a country where the statutory tax rates are low or where generous tax concessions or incentives are offered. The competitive advantage that a country gets from offering tax concession may be short lived. Other countries seeking to compete for foreign investment may feel compelled to offer a comparable package of tax concessions. The result may be harmful tax competition among countries that ultimately may work to their collective disadvantage. In an environment of tax competition among countries, the countries with the greatest need of investment capital are likely to suffer, for they will experience the detriments of granting tax incentives without attracting significant new foreign investment.

12. For many centuries, individuals have derived substantial incomes from investments or from business or professional activities carried out in foreign countries. The number of people engaging in these activities has increased exponentially in recent years, due to reduced costs of travel, technological advances in communications and in the transfer of funds, and more convenient and less expensive institutional arrangements for holding assets abroad. Many individuals holding foreign investment assets are tempted to under-report their income from those assets, in the firm conviction that their national tax administration does not have ability to find them out. In many cases, the assets are held in tax havens a country or territory that has little or no taxes. Many tax havens cater to tax evaders by providing them, inter alia, with effective immunity from discovery of their banking transactions. Many hedge funds, investment funds, and mutual funds have established their residence in a tax haven country that offers such immunity from discovery. The total deposits reported by some of the tax haven countries far exceed their GDP and are disproportionately large compared to their economies and the number of their inhabitants.

13. The advent of new and innovative financial instruments, such as derivatives and similar financial products, has created complex problems for tax administrations and has increased the possibilities of harmful tax competition. It is becoming increasingly difficult for governments to trace the income generated by these financial instruments, to determine the location or the source thereof, and to identify the taxpayer who has earned the income. Very few attempts have been
made to crystallize the legal position concerning the taxation of income attributable to new financial instruments. In the taxation of income derived from these financial products, tax policies are lagging behind technical developments. As financial markets become increasingly integrated and complex and as capital movements intensify, national tax administrations cannot keep pace with these issues in a comprehensive manner. The daily transfers of these derivative financial products are measured in the trillions of US dollars, and their total value exceeds the total gross domestic product of the entire world. In most cases, these capital movements do not leave a trace in terms of an actual movement of money. As a result, a tax department would have extreme difficulty in determining the taxable income associated with these capital movements and in allocating that income to specific countries.

14. Information exchange through bilateral tax treaties cannot solve the problem of tax haven abuses because abusive tax havens generally do not enter into tax treaties. Any solution must come through the mutual cooperation of a large number of countries. In recent years, the OECD has taken a leadership role in combating tax haven abuses through its project on reducing harmful tax competition. Developing countries, however, also have an interest in attacking tax haven abuses, for mechanisms used for avoiding taxes in developed countries are likely to be equally effective in developing countries. One partial solution to the flow of unmarked income across borders is to require some minimum level of withholding at source. This approach can be effective because the tax haven country is rarely a source country. A mix of source and residence taxation almost certainly would provide a better framework for addressing cross-border tax evasion than a framework based solely on the residence principle.

Avoidance of double taxation

15. The conclusion of bilateral tax treaties for the prevention or elimination of double taxation has emerged since the 1960s as a salient feature of inter-State economic relations. In fact, double tax conventions are now the established way for States to agree at the international level on the resolution of double taxation problems that arise in levying personal and corporate income taxes on cross-border activities of their residents and nationals. There have been some attempts to move away from a regime of bilateral tax conventions to one of multilateral conventions. They have had only partial success, the most successful being the Nordic agreements involving Denmark, Finland, Iceland, Norway, Sweden and Faeroe Islands. The multinational agreements have normally followed the patterns of bilateral double tax conventions and are, to some extent, a technique for achieving uniform bilateral agreements between members of the participating group.

16. Each convention is a compromise between the internal laws of the two Contracting States that are parties to the convention. These individual compromises have come to take standard forms. The OECD model treaty has been the basis for virtually all tax treaties between developed countries since it was first published in draft form in 1963 and finally published as the OECD Model Double Taxation Convention on Income and on Capital in 1977. The OECD Model Tax Convention is not concerned, however, with the way in which each of the Contracting States puts the obligations of a convention into effect. Similarly, most double tax conventions are silent
about how the Contracting States will give effect to them. This is an issue for the internal (constitutional) law of each State. Under the constitutions of some States, treaties come into force directly, whereas in other States additional legislation is needed. That legislation is required so that individual taxpayers may benefit from, or be directly subject to, the provisions of the conventions of which their State is a party.

17. The domestic legislation of many developed countries provides unilateral relief from double taxation. However, unilateral double tax relief by the investor’s country sometimes frustrates developing countries’ aim of providing the foreign investor with tax benefits. When the double tax relief provided by a developed country entails only a reduction in that country’s tax equal to the foreign tax actually paid, any relief given by a developing country with regard to profits currently taxed in a developed country may result (depending on the taxpayer’s circumstances) in an increase in the developed country’s tax. In the end, it is as though the treasury of the developing country transferred the amount of the tax it has forgone to the treasury of the developed country. The foreign investor pays the same amount of tax but pays more to the developed country and less to the developing country. Many tax treaties between developed and developing countries address this issue through the practice known as "tax sparing." Under a tax sparing provision, the developed country typically agrees to allow its foreign investors in the developing country to claim a tax credit for the amount of taxes that they would have paid but for the tax concession granted by the developing country. The United States is the only developed country that does not provide tax sparing in any of its tax treaties. Despite its popularity in some quarters, the practice of granting tax sparing credits is controversial, due to disagreements over its effectiveness, its benefits relative to costs, its impact on tax competition, and its effect on tax equity.

18. Experience has shown that unilateral measures may not be fully adequate to eliminate or alleviate the effects of double taxation. This inadequacy stems from the diversity of tax systems, which, in turn, originates from differences among countries in legal and tax history, fiscal policy, revenue needs, and the level of compliance and enforcement. These differences are reflected in the approach that a country takes to the promotion of foreign investment, the characterization and computation of taxable income, and the various methods used for allocating income to domestic and foreign sources. As a result of the growing complexity of tax systems and the multiplicity of taxes levied, it has become increasingly difficult to provide fully effective relief from international double taxation through the unilateral approach.

19. Bilateral tax treaties can solve many double taxation problems by reconciling differences in the concepts of various types of income and their geographical source, establishing a common method of determining how certain items of income shall be classified and taxed, and either

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assigning exclusive tax jurisdiction over certain items of income to one of the treaty countries or dividing the tax revenue between the two countries when neither is willing to relinquish its claim entirely. Furthermore, in many cases capital exporting countries have granted relief under bilateral treaties in forms that they are not prepared to extend indiscriminately by statute. For example, some capital exporting countries whose internal legislation provides no significant relief from double taxation or provides relief essentially through the credit method have agreed under bilateral treaties to exempt from taxation income generated in the other treaty countries or to tax such income at a reduced rate. Conversely, capital importing countries may grant considerably more far-reaching tax relief under a treaty than that available to investors residing in non-treaty countries. Tax treaties thus permit a degree of mutual accommodation that is not possible under the much less flexible statutory schemes applying to transactions with all countries in general. Additional benefits of such treaties, and of the orderly international tax relationships created by them, are the exchange of fiscal information and procedures for mutual assistance among the Contracting States and the customary non-discriminatory clause of the treaties, which puts local businesses owned by foreign investors on an equal footing with local businesses owned by local investors.

20. Bilateral tax treaties have been negotiated in the light of various monetary, fiscal, social and other policies important to the negotiating parties. Conclusion of a treaty between two developed countries is facilitated by their approximately similar levels of development, so that the reciprocal flows of trade and investment and hence the respective gain or loss of revenue to the parties from reducing taxes on those flows have been relatively equal in magnitude. The presumption of equal reciprocal advantages and sacrifices underlying treaties between developed countries is not valid when the negotiating parties are at vastly different stages of economic development. In addition, a loss of revenue that may be of relatively minor importance to a developed country can constitute a heavy sacrifice for a developing country. For many developing countries, the scarcity of foreign exchange resulting from outflows of tax exempt locally produced income may be of even greater importance than the loss of revenue. Consequently, developing countries have, generally speaking, been reluctant to enter into tax treaties under which their tax revenue from locally produced income and their foreign exchange reserves might be reduced unless they can reasonably assume that the treaties will ensure that those detriments are likely to be offset by benefits flowing from the treaty.

21. With a view to promoting the conclusion of bilateral tax treaties between developed and developing countries that would be beneficial to both parties, the United Nations deemed it desirable to follow in the footsteps of the League of Nations and develop its own model convention. The United Nations efforts to that end originated in Economic and Social Council resolution 1273 (XLIII) of 4 August 1967 which requested the Secretary-General to "set up an ad hoc working group consisting of experts and tax administrators nominated by Governments, but acting in their personal capacity, both from developed and developing countries and adequately representing different regions and tax systems, with the task of exploring, in consultation with interested international agencies, ways and means for facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of
possible guidelines and techniques for use in such tax treaties which would be acceptable to both
groups of countries and would fully safeguard their respective revenue interests." Pursuant to
that resolution, the Secretary-General set up in 1968 the Ad Hoc Group of Experts on Tax
Treaties between Developed and Developing Countries, composed of tax officials and experts
from twenty countries.

22. The Secretary-General in his report to the Economic and Social Council at its first regular
session, 1978 (E/1978/36), indicated that there was a need to familiarize tax officials with
approaches and methods used in the field of international taxation and that it would therefore be
desirable for the consolidated guidelines to be supplemented by explanations of those basic
approaches and methods. In 1979, the United Nations published the *Manual for the Negotiation
of Bilateral Tax Treaties between Developed and Developing Countries*. The Group of Experts
also reviewed the draft United Nations Model Convention at its Eighth Meeting held at Geneva
from 10 to 21 December 1979 and adopted the final text of the Convention and of the
commentary thereon. In 1980, the United Nations published the *United Nations Model Double
Taxation Convention between Developed and Developing Countries*.5

23. A research project carried out by an international fiscal organization to assess the impact of
the United Nations Model Double Taxation Convention between Developed and Developing
Countries found that a large number of treaties contain provisions that are included in the United
Nations Model Convention and not included in the OECD Model Convention. The study found
that from 1 January 1980 until 1 April 1997, 811 bilateral tax treaties were entered into. Of that
number, 697 treaties were finalized by developing countries with either a developed or another
developing country and 114 treaties were concluded between members of OECD countries.
There were 27 provisions of the United Nations Model Convention that either were not found in
the OECD Model Convention or differed from its corresponding provisions. The study covered
26 of them, examining whether each of these provisions was included in each of the 811 bilateral
tax treaties. The study determined that hundreds of the bilateral treaties contained provisions
recommended only in the UN Model Convention. The results of the research are shown in
Annex I.

24. By its resolution 1980/13 of 28 April 1980, the Economic and Social Council renamed the
Group of Experts as "Ad Hoc Group of Experts on International Cooperation in Tax Matters" and
increased its membership from 20 to 25. The membership includes experts and tax
administrators from 10 developed and 15 developing countries and economies in transition.
Presently, the Group of Experts is composed of members from the following countries, namely,
Argentina, Brazil, Burkina Faso, China, Côte d'Ivoire, Egypt, Finland, France, Germany, Ghana,
India, Indonesia, Israel, Jamaica, Japan, Mexico, Morocco, The Netherlands, Nigeria, Pakistan,
Palestine Authority, the Russian Federation, Spain, Switzerland, the United Kingdom and the
United States of America.

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25. In the 1990s, the Ad Hoc Group of Experts on International Cooperation in Tax Matters recognized that sufficient changes had taken place in the international economic, financial and fiscal environment to warrant a reexamination of the 1980 Model Convention and Manual. Those changes included the advent of new financial instruments, the introduction of new transfer pricing mechanisms, the growth of tax havens, and the globalization affecting international economic relations. In addition, the OECD Model Convention had undergone a major revision in 1992 and had been revised further in 1994, 1995 and 1997. Consequently, the Eighth Meeting of the Group of Experts held in Geneva in December 1997 established a Focus Group, to proceed with the revision and update of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries. Thus, the revision and update of the United Nations Model Double Taxation Convention between Developed and Developing Countries was undertaken by the Group of Experts, Focus Group and Steering Committee under the overall guidance and supervision of Mr. Abdel Hamid Bouab, Officer-in-Charge, Public Finance and Private Sector Development Branch, Department of Economic and Social Affairs, United Nations and Secretary Ad Hoc Group of Experts and assisted by Mr. Suresh N. Shende, Interregional Adviser in Resource Mobilization and Assistant Secretary of the Group of Experts.