The Effect of Double Tax Treaties on Foreign Relations

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A) Introduction

Tax treaties have existed for more than 100 years. While earlier often overlooked by the international public, the matter has reached a broader audience due to the recent discoveries of tax avoidance by Multi-National Enterprises (MNEs) and the following BEPS (Base Erosion and Profit Shifting) project, by which tax avoidance and distributive problems regarding the increased digitalisation are addressed. Additionally, Russia's suspension of Double Tax Treaties (DTT) with nations that imposed sanctions has shown the public that some states see DTT as an instrument for geopolitical influence (Nautiyal & Tiwari, 2023). But other nations intertwine tax treaties with other political concerns as well. The US does not grant unilateral benefits to taxpayers if it has, e.g. severe relations with the other countries where the taxpayers are active (United States IRC § 901(j)). China, which has signed over 100 tax treaties (Christensen & Hearson, 2022), is said to challenge international tax rules and try to prevent its companies from foreign taxation(Christensen & Hearson, 2022) by prioritising sovereignty and participating only on its terms(Christensen & Hearson, 2022). Those aspects show that while taxation is sometimes seen as merely the bureaucratic side of public finance, there might be a broader political impact. It is time to look at DTT, the question of what they are used for, and how this can influence international diplomacy besides sending a message by terminating them. This article will examine whether tax treaties are an overlooked aspect of international diplomacy or merely a tool for bureaucrats. At first, it will explain what DTTs are, then examine their (expected) effects before addressing their potential impact on foreign policy. Before a conclusion, recent changes in the international tax regime are discussed.

B) What are Double Tax Treaties?

DTTs are treaties between two or more states. (Even though there is a multilateral tax treaty between the Nordic countries (Helminen, 2014).) They were initially designed to tackle the problem of Double Taxation (DT). This problem can arise as states often tax residents based on their worldwide income and non-residents based on their domestic income. To prevent tax rates of up to 75 % (see e.g. § § 32a I 2 Nr. 5 German EStG and § 33 I 1 Austrian EStG) due to an accumulation of the rates or a miscoordination regarding the qualification of the tax subject or object, the contracting states divide their existing taxing rights on the income. Double Tax Treaties are, therefore, limiting the taxing rights of the contracting states. They do not create new taxing rights(Lang, 2021). The treaties are usually based on a Model Tax Convention (MTC), mainly the OECD MTC (Lang, 2021). MTCs are, as the name indicates, a model for tax treaties. They strive to form a common ground for all the countries included in the draft of the MTC to make the subsequent bilateral negotiations between them easier. Other important conventions are the UN Model Convention (United UN, 2018) and the US Model Convention (Treasury, 2016). Since the OECD MTC is designed to consider the economic situation between developed, or capital-exporting, countries, the UN designed its MTC to take into account the economic situation of developing countries. It provides for more extensive taxation in capital-importing countries. Due to the widespread use of those conventions, other MTCs that go in different

directions lack acceptance. After rejecting treaties for a long time to protect its tax base, Columbia tried to enter the world of tax treaties with its own MC, which was ultimately rejected as a base for negotiations by other countries (Lang et al., 2012). That shows the importance not just of existing structures in the international tax regime, but also of the achieved and commonly accepted solutions.

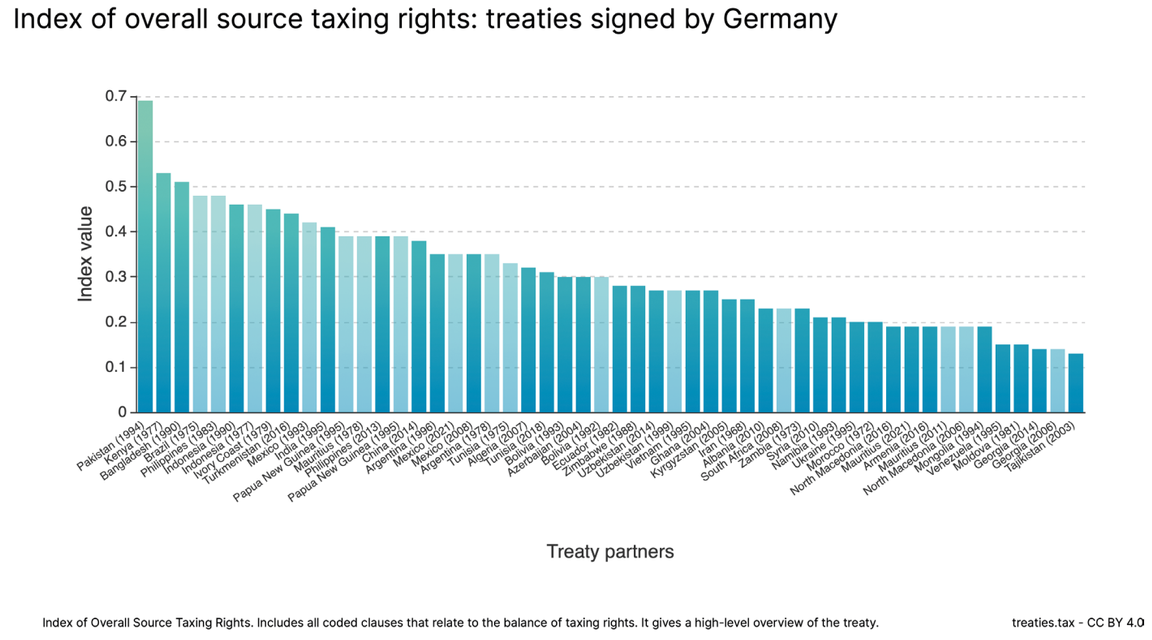
As they all stem from the OECD MTC, they all usually have the same content: The personal and material scope is followed by definitions. After that, the taxing rights on the specific types of income (e.g. interest, royalties, dividends, business income, or employment income) are divided between the contracting states. They are divided between a "resident state" and "the other state" (informally referred to as the source state). It is important to remember that both countries are the "resident state" as the "other state", depending on the flow of the transaction at hand. The following method article addresses how the states are restricted in their taxing rights if they are required to provide relief from double taxation. There are two main methods for avoiding double taxation: The credit method, by which the foreign tax is credited to the domestic tax, and the exception method, by which foreign income is excluded from the domestic tax base. The treaties are then usually ultimately concluded by rules concerning arbitration, non-discrimination, and exchange of information. Those regulations, which have lived in the shadows for a long time, are increasingly moving into the spotlight of public debates, as they are an essential factor in tackling tax avoidance.

It is also important to remember that it is first the tax administration and then the courts of each contracting state that decide about the interpretation of tax law. Even though some DTTs provide for the possibility of a mutual agreement procedure and arbitration, these two dispute resolution mechanisms are only sometimes helpful to the taxpayer (Pistone, 2020). The mutual agreement procedure sometimes even ends up being a negotiation between the governments of the contracting states, not about the law but about who receives the taxing rights (Lang, 2021). Hitherto, there is no superior oversight of the state's compliance with tax treaties or their interpretation. (Lang, 2021)

C) What are the Effects of Having Double Tax Treaties?

As mentioned, the main effect of DTT is usually described as preventing double taxation and fostering cross-border economic relations (Lang, 2021). The assumption that DT is harmful and should be avoided is a principle in the international tax regime, as it is in the national interest of all countries (Dagan, 2000). The norm is that residence countries yield primary taxation to the source (Ring, Winter 2007). The desired effect of reducing DT is minimising the cost of businesses by reducing interest, royalty, and dividend taxation. Additionally, an international exchange of labour is promoted.

Double Tax Treaties:
Treaties between two states by which the states restrict their taxing rights and thereby avoid double taxation. Whether a treaty grants more taxing rights to the state where the taxpayer is a resident or the other state can have a serious impact on the states' revenue.



But to be more precise, DTTs usually solve a coordination problem (Hearson & Prichard, 2018). The main reason for double taxation is that the taxation of residents' worldwide income and the domestic income for non-residents is also addressed unilaterally by the resident state. The resident state usually waives its taxing right for the foreign income of residents if this income is also taxed abroad (Eg Germany by § 34c EStG). Therefore, DTTs usually only resolve the issue of double taxation in special cases where the qualification is disputed. They also decide how it is avoided, thereby allocating taxing rights (Brooks & Krever, 2015).

The traditional view on how the taxing rights are divided has been challenged in recent years. The BEPS Project has started to shift the focus to the source jurisdictions. With this project, started in 2013, the OECD tries to tackle base erosion and profit shifting, as well as the new distributive questions that arise from the digitalisation of the economy, by establishing a new division of taxing rights (OECD, 2021). Additionally, China has tried to gain more taxing rights over foreign companies in its consumer market in recent years, which India and South Africa supported (Christensen & Hearson, 2022).

With China a powerful new player emerged that challenges the limited market taxation in its own jurisdiction (Christensen & Hearson, 2022). On the other hand, China is pushing for limited source taxation in foreign jurisdictions, usually less developed countries, where it is seen as a resident state (Christensen & Hearson, 2022). This double-faced approach is complemented by its push for "location-specific advantages" (Hearson & Prichard, 2018), by which China essentially tries to enhance the value assumed to be created in a country for tax purposes. It is trying to cherry-pick the advantages that suit its interest the best in each case without following a convincing line that other countries could follow completely. As an argument, it can primarily provide only its economic power, not a clear reasoning.

Some often-overlooked aspects of DTT are the increased certainty, stability, and administrability – in short: reduction of the bureaucratic burden (Dagan, 2000) - that accompany the treaties. Each state can collect the taxes it finds easier to collect due to an existing link in the respective country that allows enforcement (Dagan, 2000), e.g. the presence of an individual or property. Standardised systems reduce transaction and enforcement costs (Dagan, 2016).

Furthermore, cooperation involves the exchange of information between the contracting states (even though criticised as hard to enforce (Dagan, 2000)) and mechanisms for dispute resolution. The exchange of information can provide the respective states with the information necessary to establish and collect tax claims.

The importance of cooperation is underlined by the fact that the denial of cooperation is even seen as a punishment (Brodzka & Garufi, August 2012).

Another advantage of DTT is that they require political contact with a country (Reese, December 1987). As being said, China is trying to exploit this aspect. It founded the Belt and Road Initiative Tax Administration Cooperation Mechanism (BRITACOM) for tax administration (Christensen & Hearson, 2022), which is intended as a further alternative for Western institutions (Christensen & Hearson, 2022).

For the US, diplomacy is an important aspect as well. That contact between DTT partners in its preliminary stage regularly expands over the pure negotiation of the treaty. Diplomatic contact with a country is also necessary before declaring it a special tax regime and denying certain treaty benefits (Christians & Ezenagu, 2016).

The following example (Baker et al., 2011) illustrates the importance of good diplomatic ties with other countries in collecting debts.

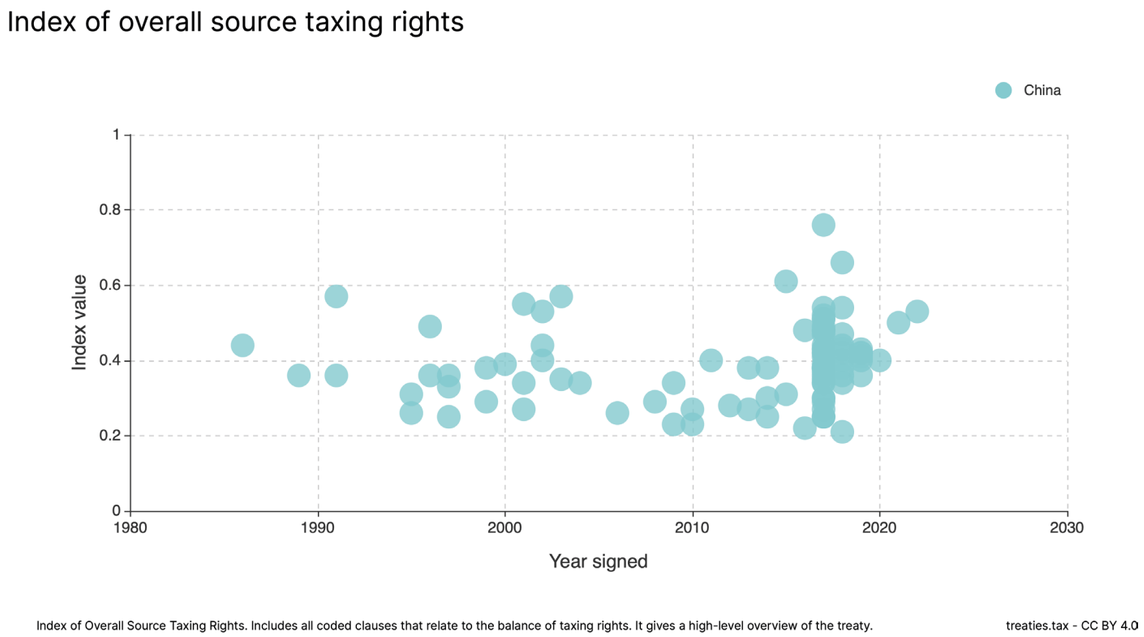
Since the 1990s, many farmers have left the Netherlands to seek their luck in countries with better economic conditions. Often, they left open a high tax bill. This put the Netherlands in a situation where they tried to invoke the mutual assistant clauses in their tax treaties with the respective countries. Those, on the other hand, were not too keen to help because of the now very one-sided use of mutual assistants, even though it was, in theory, reciprocal. Due to diplomatic efforts, the Netherlands was able to propose and execute an option that only required the minimum effort of the requested state. By this approach, the Netherlands ultimately recovered a very high rate of 90 % of the claims. (Baker et al., 2011)

Furthermore, DTT come along with prestige. The loss of international recognition is a soft law instrument that can be politicly used (Brodzka & Garufi, August 2012).

That brings us to the question of whether to achieve the aforementioned goal (prevention of double taxation, economic growth, and diplomatic contact), it is better to use a DTT or to act unilaterally.

In general, sufficient unilateral measures exist to prevent the majority of double taxation cases (Baker, 2014; Dagan, 2000). Therefore, DTTs provide for coordination between the contracting states about who gives up their taxing rights.

But a big problem remains. The interests of capital exporting and capital importing countries divert (Graetz & O'Hear, March 1997). While the exporting countries are more interested in taxation in the resident states, the capital importing countries are more interested in taxation in the other, or "source" state.



As a significant capital-exporting state, laws to avoid double taxation were established in the US because fairness towards the taxpayer was more important than losing revenue (Graetz & O'Hear, March 1997). The relief of double taxation was included in a bill to encourage investment in Europe in general (Graetz & O'Hear, March 1997). The primary objective of the US lies in the collection of US tax on US-sourced income (Graetz & O'Hear, March 1997).

Capital-importing countries, in contrast, are more interested in taxation at the source or no taxation to enhance Foreign Direct Investment (FDI) (Dagan, 2000), as, for example, the negotiation process of Zambia's DTT has shown (Hearson, 2022). Often, they don't even have comprehensive taxes on income (Christians, 2003), or don't effectively enforce them (Christians, 2003). The DTT they favour contains tax-sparing clauses that are supposed to facilitate foreign direct investment (Navarro, 2021). Developing countries often provide tax incentives. The tax-sparing clauses ensure that those incentives are not eradicated by DTT (Navarro, 2021). This is diametrically opposed to the fact that the effect of tax-sparing clauses, and even of DTT, is unclear (Christians, 2003; MacDaniel, 2003; Navarro, 2021). The necessity of DTT, at least for developing countries, is therefore sometimes denied (Ring, Winter 2007). With a DTT, a smaller portion of the taxes would go to the host countries since the host countries' tax rate is reduced (Dagan, 2000). The high costs connected with negotiating and ratifying a treaty would not be worth the effort (Baker, 2014). The DDT could be seen as a signal that the country is playing by the international rules (Ring, Winter 2007), may even be the most crucial aspect for developing countries (Dagan, 2000). That fact is, however, not seen as relevant enough to influence FDI (Baker, 2014).

Nevertheless, FDI is regularly promoted as an effect of DTT (Christians, 2003) and the objective of developing countries, e.g.

Zambia (Hearson, 2022). Additionally, one may remember that FDI is not the only possible benefit of a treaty.

The lower threat of double taxation should not distract from the fact that cooperation is still necessary to include all the details required to prevent double taxation to the most extensive level (Ring, Winter 2007). While many unilateral solutions aim to avoid double taxation, one should recognise the relevance of DTT for personal taxation, where even minor coordination problems can have personal effects (Baker, 2014). Other benefits than the avoidance of double taxation might not be as "heroic" (Dagan, 2000) as the prevention of double taxation, but they are nevertheless important.

D) How Do Those Effects Reflect on Foreign Policy?

I) Increased Revenue and Economic Growth

Most states strive to increase their revenue and their economic growth. The resident state can increase its revenue if the source state agrees to limit its taxation (Brooks & Krever, 2015). Usually, a treaty will benefit all parties, even though some conflict of interest remains (Chisik & Davies, 2004). However, that benefit is diminished if the FDI between those countries is asymmetric (Chisik & Davies, 2004). That is usually the case between developed and developing countries. Since the effect of DTT on FDI remains to be determined (Christians, 2003; MacDaniel, 2003; Navarro, 2021), it is not certain that the expectation of a higher FDI will influence DTT in the future in developing countries. Higher administrability and certainty will have a significant effect on developed countries since those countries often prevent double taxation unilaterally.

Those countries are also in a different position regarding the following effect.

II) Bargaining Chip

By agreeing to treaty provisions that are, at first glance, less beneficial, countries can obtain a bargaining chip for other negotiations.

China, for example, has a powerful bargaining position due to its large and attractive markets (Christensen & Hearson, 2022) it already achieved a very beneficial outcome in the 1980s in its DTT with the US. That DTT was also the first to be signed by a US President (Statement of Ronald A. Pearlman 1985). It was so beneficial towards China that the Senate Committee clarified that this would not be seen as a precedent for other DTT negotiations (Reese, December 1987). This example illustrates how geopolitically important countries are often able to receive a benefit compared to countries that cannot deliver a strategic advantage to the partner of the DTT (Reese, December 1987).

On the other hand, most developing countries are in a worse bargaining position due to a lack of bureaucrats, tax specialists (Hearson, 2022), and offers they can make to other countries. Some authors have gone so far as to describe them as being "forced" by a prisoner's dilemma since they are participating in a race to the bottom to offer the best conditions to capital-exporting countries (Baistrocchi, 2008).

It has been shown that European countries, by trying to compete with China in Africa, are trying to achieve deals that are at least equal to the ones with China (Hearson, 2022).

The tax-sparing clauses sometimes included in treaties with developing countries are seen as a concession, which has to be "bought" by other concessions of the capital-importing states (Ashiabor, 1998). Since the US usually denies such clauses, the developing countries can achieve other benefits (Navarro, 2021). Other possible benefits the developing countries could achieve include lowering the threshold for assuming a permanent establishment that allows taxation in the source state or higher withholding taxes (Christians, 2003).

III) Diplomatic Contact

While it is hard to measure the effects of diplomatic contact with a country, the existence of diplomatic contact with another country is something that cannot be achieved unilaterally. Of course, diplomatic contact cannot be exclusively achieved through tax treaties. Still, the contained mutual agreement and arbitration procedure pose a possibility for contact between the two nations besides other areas of foreign policy.

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E) The New International Tax Regime

In the past decade, we have experienced "the most extensive attempt to change international tax norms since the 1920s" (Grinberg, June 2016). With the BEPS Project, we have seen a new form of cooperation to tackle base erosion and profit shifting as well as a redistribution of taxing rights. The project is going to impact Chinese multinationals just as American (Christensen & Hearson, 2022). That poses the question of whether the BEPS projects, resp. recent developments are weakening the bargaining position of individual countries.

First, it should be noted that the formerly strong position of the US was weakened during the BEPS negotiation. That was firstly since subsidiaries of US parent companies, based on the increased digitisation, were able to deal with each other directly and exclude the parent company, therefore also the US Internal Revenue Service (IRS), and secondly because of the gridlock on (domestic) tax reforms (Grinberg, June 2016). This is a general symptom, showing that the ultimate resident states of MNEs are no longer equipped with a strong bargaining position.

The global financial crisis altered the way of decision-making worldwide towards more multilateral cooperation in tax matters to increase state revenue (Grinberg, June 2016). That resulted in issues such as Transfer Pricing being discussed publicly and at higher levels of government (Grinberg, June 2016). So far, 102 countries have signed the Multilateral Instrument (MLI) by which the BEPS rules are to be implemented (OECD, 2024).

It is fair to assume that questions regarding

international taxation are better coordinated than they were 20 years ago. There are still powerful leading countries required to lead the negotiations (Grinberg, June 2016). But their influence on the outcome has declined.

Nevertheless, aside from the MLI, which shall have a direct effect, the inclusion of new rules by the OECD or the UN does not have a direct effect. Often, there are no coercive measures to ensure compliance, but only the respective countries' reputations are at stake (Grinberg, June 2016). In the case of distributive problems, soft law is unlikely to work (Grinberg, June 2016). Even though there are instruments, like the Global Forum, those are usually not enforceable (Brodzka & Garufi, August 2012; "Lotus," 1927). Additionally, multiple countries are (preparing) to mock compliance (Grinberg, June 2016). Finally, it is to be noted that the new tax regime still poses unresolved issues for developing countries (Hearson & Prichard, 2018). Even with the best international regime, the effect is only as good as it can be applied internally, which often poses a problem for developing countries.

F) Conclusion

In the past, DTT have been influenced by and have affected not tax-related areas of policy, mainly the closely connected state revenue and economics, but, in its role as a bargaining chip and a method of establishing diplomatic contact, other areas of politics as well. With rising doubt of the effect of FDI in literature, it is unclear whether this area will still be relevant in the future. DTT remain an essential factor in influencing state revenue and thereby remain a bargaining chip for other matters. The diplomatic contact provided by the negotiation of DTT and resolving disputes arising from them stay important. With the shift in public attention towards tackling tax avoidance, political processes have also shifted. The increased attention that tax treaties now receive has resulted in a greater effort from international organisations like the OECD, the G20, and the UN. That increased effort can, however, not distract from the fact that the final tax treaties are usually still negotiated bilaterally and, therefore, open to influences from other areas of policy.

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