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Blunt Double Edged Sword: Double Taxation and the Impact on the Taxpayer in Cross -Border Transactions

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Abstract

Double taxation agreement is a mechanism which protects the taxpayer from being subjected to taxable liability in two separate jurisdictions. Many scholars argue that this concept encourages taxpayers to fulfill their fiscal duties. This paper attempts to examine the principles of international double taxation and the role of double taxation agreements in improving the tax system of a nation. Double taxation agreements have the potential to improve certainty for taxpayers and tax authorities. This is done by reducing double taxation, eliminating tax evasion, and encouraging cross-border trade efficiency. The author also attempts to critically assess the impact of the three aforementioned factors considering international treaties. Furthermore, the writer submits three key issues that are critical to be noted in the present discussion regarding principles of double taxation and the role of DTAs: (a) Issues arising from DTAs as bilateral agreements, (b) role of DTAs as a prevention mechanism for harmful taxation and (c) the status of principles of non-disciplinary taxation.

Keywords: *Reducing Double Taxation, Cross-border Transactions, Tax Evasion, Cross-border Trade Efficiency*

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Introduction

Taxation is commonly regarded as the primary source of revenue of a State[1]. As a rule of thumb[2], the State of residence is entitled to the collection of taxes from individuals and corporations[3]. While the above is generally practicable in the domestic forum, internationally it may be a highly contested matter. Scholars cite double taxation upon the same taxable source, gaps in law which allow the fraudulent evasion of payment of taxes and, *inter alia*, inter-state disputes as reasons for the aforementioned[4]. International Double Taxation Agreements ("DTAs") are considered to be a system to overcome such challenges[5]. DTAs are signed between States to identify the possibility of double taxation of the same income in both countries and attempt to minimise or avoid such scenarios[6].

The objectives of the research are twofold: (i) To identify the role of double taxation and (ii) To evaluate if DTAs have the potential to improve certainty for taxpayers and tax authorities by reducing double taxation, eliminating tax evasion, and encouraging cross-border trade efficiency. The writer argues that, while DTAs are a plausible approach to mitigate the negative consequences of the possibility of double taxation, it is not without flaws. In proving the above, the writer critiques each point by submitting scholarly opinions, examples from State practices and principles of international double taxation. The writer concludes by making some additional observations on the principles of double taxation and features of DTAs.

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[1] John Snape, The 'Sinews of the State': Historical Justifications for Taxes and Tax Law in Monica Bhandari (ed.), Philosophical Foundations of Tax Law (OUP 2017),p.10; See also, Stuart P. Green, Tax Evasion as Crime, in Monica Bhandari (ed.), Philosophical Foundations of Tax Law (OUP 2017) pp. 59-60

[2] Subject to some considerations which has been dealt with in the first assignment by the writer; See generally, S. Balaratnam, Income Tax in Sri Lanka:The Rules, The Principles and Practice of Income Tax (6th ed., Tax Publications Ltd. 2018), p. 236

[3] Reuven S. Avi-Yonah, International Tax as International Law (CUP 2007), p. 5; See also, Omri Marian, 'Function of Corporate Tax-Residence in Territorial Systems' [2014] 18 Chapman Law Review , p. 157

[4] W. H. Coates, 'League of Nations Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Jasiah Stamp' [1924] 87 Journal of the Royal Statistical Society, pp. 99-101; E. Gooneratne, Income Tax in Sri Lanka (Aitken Spence Printing 2009), pp. 500-501

[5] Anh D. Pham, et al., 'Double Taxation Treaties as a Catalyst for Trade Developments: A Comparative Study of Vietnam's Relations with ASEAN and EU Member States' [2019] 12 Journal of Risk and Financial Management, p. 172

[6] Mogens Rasmussen, International Double Taxation (Alphen aan den Rijn: Wolters Kluwer Law International 2011), p. 204; Angharad Miller, Lynne Oats, Principles of International Taxation (5th ed., West Sussex: Bloomsbury Publishing, 2016), pp. 110-113

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For the purpose of this essay, tax treaties and Double Taxation Treaties refer to DTA.

Role of Double Taxation Agreements

Balaratnam argues that DTA between States protect individuals and corporates[7]. He further notes that it helps the States in agreement to recognise and clarify which sources that they may be entitled to tax in the course of assessment[8]. Scholars have opined that DTA primarily serve three purposes, which will be individually discussed under this portion of the essay.

a. Reducing Double Taxation: Do treaties reduce double taxation in all situations?

Primarily, DTA estops one State from taxing a legal personality on a taxable source which has the possibility of being taxed abroad[10], particularly where the source of the income rests. DTA protects the individual person or corporation from being taxed twice[11]. Generally, the place of residence will be entitled to levy taxes[12].

International principles on DTA mandates reciprocity in terms of the applicable taxation on disputed taxable sources[13]. This is also manifested in the Organisation for Economic Co-operation and Development ("OECD") Model DTA[14]. This creates an environment of non-discrimination as none of the States party to the DTA will be allowed to impose higher

[7] Balaratnam (n.2), p.236
[8] Ibid., pp. 236-237
[9] Pham (n.5), p. 176:"…[T]he double taxation treaty ascertains the taxing rights between signatories for the avoidance of double taxation and the prevention of fiscal evasion, alongside the removal of tax barriers to foreign trade."
[10] Reuven S. Avi-Yonah, Double Tax Treaties: An Introduction (OUP 2009), available at <https://repository.law.umich.edu/book_chapters/131> accessed on 21 July 2021, p.99; See also, D. D. M. Waidyaratne, Taxation Fiscal Policy and the Economy in Sri Lanka (Stamford Lake 2012), pp.305-306
[11] Edward J. McCaffery, James R. Hines, Jr, The Last Best Hope for Progressivity in Tax [2009] University of Southern California Law School Law and Economics Working Paper (Series No. 92), p. 82
[12] Patrick Emerton and Kathryn James, 'The Justice of the Tax Base and the Case for Income Tax', in Monica Bhandari (ed.), Philosophical Foundations of Tax Law (2017), OUP, p.163
[13] Peter Harris, David Oliver, International Commercial Tax (2010), CUP, pp.4, 104-105, 114
[14] OECD (2012), Model Tax Convention on Income and on Capital 2010 (updated 2010), OECD Publishing, available at <http://dx.doi.org/10.1787/978926417517-en> accessed on 22 July 2021, Art.24(1); See generally, Avi-Yonah (2009) (n.10), p.100

taxes on similar sources which arise in its counterpart's jurisdiction[15]. The extent to which DTAs favour both taxpayers and tax collecting States are apparent.

In the event of a conflict between a DTA and domestic laws, the provisions of the treaty must prevail[16]. In the same light, if the State attempts to reconsider its domestic tax policy, the DTA will be an infringement on its right to do so[17]. The doctrine of reciprocity may not be applicable in situations such as the US model of DTAs[18]. While tax laws are passed by the Congress in the US, DTA are ratified only by the Senate. This suggests that the DTA can, *prima facie*, contravene the domestic law.

The above situation gives rise to two issues. First, the State fails to exercise its sovereignty over domestic tax subjects as a result of its international obligations. Taxation allows the State to stabilise its social and economic standpoint. The DTA may act as a barrier than a supporting factor to the State. However, nothing bars the State contemplating an alteration to reduce taxes[19]. Second, in the event of a discrepancy between the DTA and the domestic taxation percentages, the resident individual or corporation will be subject to discrimination as they do not have the right to enjoy the rates agreed between the States and imposed in the other jurisdiction[20].

b.Eliminating Tax Evasion: Do treaties eliminate the evasion of taxes in all situations?

Some scholars argue that the main purpose of a DTA is not to prevent

[15] See generally, Bachmann v Belgian State [1992] C-204/90 (ECJ); Deutsche Shell v Finanzamt für Grossunternehmen in Hamburg [2008] C-293/06 (ECJ), ¶¶ 37–40; Cadbury Schweppes [2006] C-196/04 (ECJ); See also, S. van Thiel, European Union: Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts [2008] 48 European Taxation, pp. 279–290, 339–50

[16] Philip B. Gurney, Corporate Taxation in Australia, Hong Kong and Singapore: Observations on Some Jurisdictional and Operational Distinctions [2006] 36 Hong Kong Law Journal, p. 268

[17] Harris (n.13), p. 18

[18] Avi-Yonah (2009) (n.10), p. 100

[19] See section 2. (a)

[20] See generally, Harris (n.13), p. 92: Such issues must be ascertained in consideration of equity and fairness; See also, OECD (2012) (n.14), p. 33

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double taxation[21], but to prevent fiscal evasion[22]. More often, this notion is reflected in the titles of DTA[23]. The most significant feature of a DTA which enables States to reduce tax evasion is the agreement to exchange information regarding tax sources and subjects[24]. This enables both State parties to identify their respective taxable sources. Given the fact that both States share information regarding their tax subjects, it is unlikely that a taxpayer can avoid paying by claiming that they are entitled to a double taxation relief as a result of being subjected to taxes abroad. It must be noted that this is a method for corporations to be active across multiple jurisdictions enjoying the public facilities and to be able to pay taxes only in its place of residence as a result of double taxation relief[25].

In Australia, a parent company can consolidate all its subsidiaries for the purpose of calculation of taxes[26]. There are two issues with this position. First, as a result of such a consolidation, shareholder dividends are not accounted in the calculation of taxes[27]. This may be considered a stunt to attract new investors and compel existing investors to pay taxes. However, when considering dividends may be excluded from the subsidiary companies, the move does not seem to serve the purpose of collection of taxes efficiently. Second, companies that are dual resident will not be entitled to the above privilege to consolidate subsidiaries[28]. Consequently, those companies will have to pay separate taxes on each subsidiary, without the exemption on the dividends. This creates animosity between the State and corporations due to discrimination and unfair treatment to

[21] Avi-Yonah (2009) (n.10), p. 99
[22] Harris (n.13), p. 18
[23] Avi-Yonah (2009) (n.10), p. 99, i. e. "Convention Between [Country X] and [Country Y] for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income."; See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income between the U.S. and Japan, 8 March 1971; See also, Jane Gravelle, Tax Havens: International Tax Avoidance and Evasion [2009] National Tax Journal, p. 727
[24] Thomas Rixen, From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance, Review of International Political Economy (Routledge 2012), p. 211; See also, M. B. Carroll, Prevention of International Double Taxation and Fiscal Evasion: Two Decades of Progress under the League of Nations, (Geneva: Series of League of Nations Publications 1939), ¶II.A.8; See also, Henry Christensen III, et al., The Amazing Development of Exchange of Information in Tax Matters: From Double Tax Treaties to FATCA and the CRS [2016] 22 Trusts and Trustees Review, p. 901
[25] Ryo Izawa, Corporate Structural Change for Tax Avoidance: British Multinational Enterprises and International Double Taxation between the First and Second World Wars (2020), Routledge, p. 4
[26] Gurney (n.16), p. 271
[27] Ibid.; See Income Tax Assessment Act (Commonwealth) (Australia) of 1997, Part 3-90
[28] Income Tax Assessment Act (Commonwealth) (Australia) of 1997, s. 6(1)

a class.

Despite the above, it has come to light that Australia attempts to "*reciprocally eliminate dividend withholding tax*" through DTAs[29]. These agreements are not idealistic models of DTAs[30], but results of political compromise[31]. Often, DTAs specify subjective clauses to reflect the correspondence between the State parties[32]. States have even conceded to this reality[33]. This becomes problematic to corporation as it creates an uncertain environment when the life of the business are reliant on the political bargaining power of States.

c.Encouraging Cross-Border Trade Efficiency: Do Treaties Always Encourage Cross-border Trade Efficiencies?

Braun and Zagler have noted that the number of DTAs signed in the recent past have increased[34]. The main reason cited to this effect is the promotion of cross-border trade and investments[35]. The question then arises as to how DTAs can positively impact cross-border trade. What is compelling in a DTA is that two States have agreed to recognise its sovereignty in taxation[36]. For a corporation which functions in the above States, this signifies certainty and security. The corporation need not fear about any *force majeure* situations as a result of any hostility between the countries. Moreover, the company can benefit from the DTA by disclosing its taxable sources, which would grant them either a tax credit or an exemption[37], which consequently promotes cross-border investments.

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[29] See Hugh J. Ault, Brian J. Arnold, Comparative Income Taxation- A Structural Analysis (2nd ed., Kluwer Law International: Aspen Publishers 2004), p. 411
[30] Miller J in Knights of Columbus v The Queen (2008) TCC 307 (TC), ¶82
[31] Harris (n.13), pp. 18-19
[32] Ibid.
[33] P. H. O'Neill, Confronting OECD's Notions on Taxation, 10 May 2001, Washington Times, op. cit. Rixen (n.24), p. 215: "George W. Bush declared that 'The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems'".
[34] Julia Braun, Martin Zagler, An Economic Perspective on Double Tax Treaties with(in) Developing Countries [2014] 6 World Tax Journal, pp. 242–281
[35] Ibid.; See generally, Pham (n.5), p. 173
[36] Avi-Yonah (2009) (n.10), p. 101
[37] Ibid., p. 100

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A common feature in DTAs is that they significantly restrict the right to tax of the source country[38]. There can be situations where one country is benefitting more than the other, when most of the sources rest in the latter State. This is a typical situation that a DTA between a developing and developed State would encounter[39]. The tax rates must be applied reciprocally[40]. Therefore, the poorer State will have the same amount which the wealthier State ought to have gained. This puts the two States in an unequal footing, as consideration is not given to the economic stature of the States when deciding tax rates.

The above shortcoming can be easily alleviated by considering how well the economy is in the two States. In such a scenario, a developing State will be entitled to more tax than a developed State. However, in reality, investors will not be attracted to a developing State when the tax rates are higher than those in developed States. This is why developing countries engage in the formulation of DTAs extensively[41]. As a result, investors are allured to invest more and engage in cross-border transactions.

2.Double Taxation Agreements: Miscellaneous Observations

In addition to salient features of DTAs, the writer submits three key issues that are critical to be noted in the present discussion regarding principles of double taxation and the role of DTAs:(a) Issues arising from DTAs as bilateral agreements,(b) role of DTAs as a prevention mechanism for harmful taxation and (c) the status of principles of non-disciplinary taxation.

a.Tax Treaties are Confined to Bilateral Agreements

Contrary to other multilateral international treaties[42], DTAs are bilateral[43]. This suggests that the taxation over sources happen in accordance with the conditions in the DTA[44]. Additionally, States are bound to enforce DTAs over domestic tax policies[45]. If taxable sources involve two or

[38] Harris (n.13), p.104
[39] Avi-Yonah (2009) (n.10), p.101
[40] See sections 2. (a) and 2. (a)(i)
[41] Harris (n.13), p.104
[42] Treaties such as General Agreement on Tariffs and Trade or GATT.
[43] Avi-Yonah (2009) (n.10), p.106
[44] Harris (n.13), p.18
[45] See section 2. (a)(i)

more countries under the same tax subject, the issue becomes highly contested[46]. Particularly, the tax subject will be liable to pay varied taxes based on DTAs, which is against the accepted equitable principles on international taxation[47].

Moreover, these bilateral treaties system is far too rigid[48]. It limits domestic tax reforms, and if a State wishes to make amends to its domestic policy, they are required to renegotiate terms with the other State[49]. Since only two States are privy to the terms of a DTA, the change in domestic policy would require the State to engage in multiple negotiations with all States they share DTAs with. This is a rather cumbersome and impractical mechanism as consequence of its rigidity.

b. Do Tax Treaties Truly Counter Harmful Tax Competition?

Harmful tax competition can be detrimental to the interests of developing States[50]. DTAs are considered to be a deterring factor on harmful tax competition[51], as it operates on principles of reciprocity. However, DTAs are usually based on existing domestic tax laws and practices of States subject to minor variations as a result of the correspondence between States[52]. This becomes an issue, as previously discussed, when developed countries engage in negotiations over DTAs with their developing counterparts. It is reasonable to assume that the DTA ultimately boils down to the bargaining power of the States[53]. This is unhealthy in the long-term. Developing countries agree to DTAs as they consider the move to be a sign of legitimacy[54]. As a consequence, they will be bound by taxation policies which may contravene their domestic policies or even be harmful for the larger economic development of the State.

[46] Harris (n.13), p. 18
[47] Ibid.
[48] Ibid., pp. 18-19
[49] Ibid.
[50] OECD, Harmful Tax Competition: An Emerging Global Issue (1998), available at <https://read.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en#page3> accessed on 30 July 2021, ¶¶45-46
[51] Harris (n.13), p.105
[52] Avery Jones, et al., The Origins of Concepts and Expressions Used in the OECD Model and Their Adoption by States [2006] British Tax Review, pp. 695–765
[53] See section 2. (b)(ii)
[54] Harris (n.13), p.104

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c.Non-discrimination Principles in International Taxation are Weak

The OECD Model, which is said to be adopted verbatim as DTAs[55], has weak provisions on non-discrimination[56]. Art.24 of the OECD Model serves a dual purpose: to prevent discrimination by a State over (i) residents and (ii) nationals of the treaty partner state[57]. Non-discrimination implications extend in light only to residents of the other State. This means that the source State will be subject to limitations, while the resident State is free to act[58]. It must be noted, however, that courts have taken a different approach, and have committed to the application of non-discriminatory principles even on behalf of source States[59]. This proves that the even the most widely accepted principles of DAT are not without flaws.

Conclusion

DTAs are a result of competing interests between States and their taxation policies. It is a protection of significant importance that is available to a person liable to pay taxes. As a consequence of circumvention of double taxation, DTAs render the benefits of eliminating tax evasion, promotion of cross-border trade efficiency, prevention of harmful taxation policies and establishment of non-discriminatory principles. However, as it was argued throughout this piece, the protections and the benefits are not flawless. In conclusion, the writer notes that the essence of this research essay is to showcase that, though DTA is no ideal mechanism to answer all concerns pertaining to double taxation with absolute certainty, the rights and privileges rendered to the taxpayers and tax authorities are satisfactory to a great degree.

[55] Knights of Columbus v The Queen (2008) TCC 307 (TC)
[56] Harris (n.13), p. 92: Referring to Art. 24 of the OECD Model Convention.
[57] Avery Jones, J., et al., The Non-Discrimination Article in Tax Treaties [1991] British Tax Review, Part I pp.359-385, Part II pp.421-452
[58] Ibid.
[59] ***Kraus v Land Baden-Wurtemburg*** [1993] C-19/92(ECJ); Cadbury Schweppes [2006] C-196/04 (ECJ); See generally, S. van Thiel, European Union: Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts, 48 European Taxation, pp.279-90, 339-350: ECJ has been restrictive in interpreting non-discrimination.