TECHNICAL NOTES AND MANUALS

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Tax Policy: Designing and Drafting a Domestic Law to Implement a Tax Treaty

By Kiyoshi Nakayama

1. Introduction

The purpose of this article is to provide introductory guidance to the tax policy department in a developing country that is expanding or is about to expand its tax treaty network on how to design and draft a domestic law to implement a tax treaty and related issues. While each treaty is different, for simplicity, my explanation cites articles of the OECD Model Tax Convention (OECD MTC).

The article consists of three parts, i.e.:

- Relationship between tax treaties and domestic laws;
- Role of domestic laws to implement a tax treaty;
- Role of domestic laws to counter tax treaty shopping.

2. Relationship between Tax Treaties and Domestic Laws

As a tax treaty reduces or exempts source country taxation, it is desirable that the relationship between a tax treaty and domestic laws be clear to taxpayers, especially those in treaty partners, in order to facilitate the smooth application of treaty benefits.

The Vienna Convention on the Law of Treaties (VCLT) provides established principles of international law. Art. 26 of the VCLT provides that *"Every treaty in force is binding upon the parties to it and must be performed by them in good faith."* In addition to this *"pacta sunt servanda"* principle, Art. 27 of the VCLT provides that *"A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."*

Despite this principle of international law, in some countries domestic laws may prevail over an inconsistent provision of a treaty. The specific relationship between treaties and domestic law and the possibility of a so-called treaty override (meaning that domestic law overrides the provisions of a treaty) depends on each country's constitution, laws, and judicial decisions. For example, the United States (US) Constitution provides that laws and treaties are of the same order of importance,[1] which is reinforced by the US Internal Revenue Code (IRC).[2] In other words, the "later-in-time" rule applies. For example, Sec. 897[3] of the IRC, which was introduced as part of the Foreign Investment in Real Property Tax Act in 1980, overrode previous tax treaties. Although the US courts have been trying to avoid a treaty override as much as possible through interpretation of legislative intent, the country's legal hierarchy creates the possibility of unpredictable consequences for its treaty partners and their residents.[4] On the other hand, the Japanese Constitution specifies that treaties prevail over domestic laws[5] and New Zealand has clarified the supremacy of treaties in its tax law.[6] In order to provide transparency and predictability to foreign investors, it is desirable to clarify whether tax treaties prevail over domestic laws in tax laws, unless the Constitution explicitly provides a rule in this regard.

There are two other important rules regarding the relationship between treaties and domestic laws, the "preservation clause" and "saving clause." The preservation clause nullifies any treaty provisions that inadvertently take away benefits otherwise permitted by domestic law. While it may appear self-evident, this principle is worth clarifying in a law or guidance in cases where a treaty does not have explicit provisions.[7] The saving clause maintains the right of a Contracting State to tax its own resident or citizen as if the treaty did not exist. This may also seem self-evident.[8] However, with regard to this principle, there has been an argument that a controlled foreign corporation (CFC) rule, which allows a country to tax its residents on income attributable to their participation in certain foreign entities, may conflict with the provisions of a tax treaty.[9] Because of this argument, some treaties now have

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[1]Art. VI(cl.2) of the US Constitution provides that, *"This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding."* The US is not a signatory to the VCLT.

[2]Sec. 7852(d)(1) of the IRC provides that, *"In general for purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."*

[3]Sec. 897 of the IRC makes gains realized from the sale of stock in a US corporation a significant portion of the assets of which consists of US real estate taxable.

[4]*See* Gustafson et al at pp. 65-66.

[5]Art. 98(2) of the Japanese Constitution provides that, *"The treaties concluded by Japan and established laws of nations shall be faithfully observed."* Art. 55 of the French Constitution states more clearly that treaties prevail over domestic laws.

[6]Art. BB3(2) of New Zealand Income Tax Act.

[7]For example, Art. 1(2) of the 2003 Japan-US tax treaty provides that, "The provisions of this Convention should not be construed to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded: (a) by the laws of a Contracting State in the determination of the tax imposed by that Contracting State; or (b) by any other bilateral agreement between the Contracting States or any multilateral agreement to which the Contracting States are parties."

[8]Some tax treaties explicitly state this principle for clarification. For example, Art. 1(2)(a) of the 2003 Japan-US tax treaty provides that, "Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4) and, in the case of the United States, its citizens."

[9]Para. 1(1) and Art. 10(5) of the OECD MTC.

a provision clarifying that the CFC rule does not violate tax treaties, while it is a common understanding among the OECD member countries that a CFC rule is not contrary to the provisions of a tax treaty.[10]

3. Role of Domestic Laws to Implement a Tax Treaty

Assuming that treaties prevail over domestic laws in your country, why are domestic laws to implement a tax treaty necessary?

If a tax treaty is self-explanatory, there is no need for implementing laws.[11] Furthermore, as Art. 3(2) of the OECD MTC provides a rule on how to interpret terms not defined in a treaty, it is difficult and unnecessary to define all terms in a tax treaty. While the rule in Art. 3(2) solves most cases, it should be kept in mind that undefined terms or terms defined in non-tax laws often lead to misunderstanding or abuse by taxpayers. Whenever a tax policy department foresees or encounters such cases, it should introduce a provision that defines the potentially problematic terms as part of the tax laws. Enacting such laws after a treaty has been concluded may require a discussion between competent authorities for clarification.

To take advantage of most tax treaty provisions reducing or eliminating source country taxation, residents of a treaty partner country must follow certain procedures. It is also difficult and unnecessary to specify the details of these procedures in a tax treaty. Thus, domestic laws or regulations or other forms of guidance[12] should set out the necessary procedures for applying for tax treaty benefits.

Needless to say, if tax treaty provisions clearly state the rights and obligations of taxpayers (treaty partner residents), such as the distribution of taxing rights between a resident country and a source country, or the non-discrimination clause, the tax treaty provisions directly apply.

In designing a law implementing tax treaties, all issues which require clarification and guidance should be considered, not only for the benefit of taxpayers or withholding agents, but also for tax officials. It should be noted that tax officials at field offices who do not understand tax treaties may make procedures to claim treaty benefits time-consuming and costly, which would undermine the intended effects of facilitating trade and investment with a treaty partner country by concluding tax treaties.

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[10]Para. 23 of the Commentary on Art. 1 of the OECD MTC. A few members put observations on this understanding.

[11]In Austria, Belgium and Germany, tax treaties are incorporated into domestic laws by a formal or procedural executive or legislative act. In Australia, Canada, Denmark, Israel, New Zealand, Norway, Sweden and the United Kingdom, a treaty does not have effect as domestic law of its own force so that treaties are incorporated into domestic law by special enactment. *See* Thuronyi at pp. 112-113, and also *Treaty Making—Expression Of Consent By States To Be Bound By A Treaty* at pp. 90-93.

[12]The US Treasury Department released Technical Explanation on each tax treaty. The Technical Explanation provides useful guidance on how to interpret and apply a tax treaty using a lot of examples, though a taxpayer can challenge interpretation shown in Technical Explanation at courts.

Examples of what should be included in a law implementing tax treaties or related regulations are:

- definition of terms which may cause misunderstanding or lead to abuse;
- procedures to apply for tax treaty benefits;
- procedures for exchange of information;
- procedures for assistance in the collection of taxes; and
- mutual agreement procedures.

3.1 Definition of Terms Which May Cause Misunderstanding or Lead to Abuse

Common cases would be a definition of "agent of independent status" in Art. 5, "royalties" in Art. 12 or "employer" in Art. 15 of the OECD MTC. While the Commentary to the OECD MTC (the Commentary) may work as guidance for interpretation, courts may not grant legal authority to the Commentary even in the OECD member countries. Thus, it could be worth clarifying the definition of terms by referring to the Commentary. On the other hand, in the case where a country takes a different view from the Commentary without making observations, it may be also worth clarifying its own definition or interpretation in a law.

3.2 Procedures to Apply for Tax Treaty Benefits

There are various ways to provide procedures for claiming tax treaty benefits such as reduced withholding tax rates on dividends, interest and royalties, and exemption. While some countries require treaty partner residents to submit a form with a self declaration of their eligibility for tax treaty benefits, others require a certificate of residence issued by the tax authorities of the resident's country. The US adopts a unique qualified intermediary (QI) program. Under the current QI program, a non-US financial intermediary receiving income from a US source for the account of its offshore customers can claim the tax treaty benefit of an exemption from US withholding tax or other certain simplified withholding and reporting responsibility by entering into a qualified intermediary agreement with the IRS.[13]

Applicable procedures may differ according to the extent of reduction of source taxation. For example, a certificate of residence may be required for claiming exemption from source taxation, while only a self declared form is required for claiming a reduction of the withholding rate. In the case that a tax treaty includes a detailed "limitation of benefits"[14] provision, comprehensible guidance should be provided by a law and regulations. Another important

[13]Under the QI agreement, QIs accept enhanced responsibilities for providing assurance that customers are in fact eligible for tax treaty benefits and exemptions such as obtaining acceptable account-opening documentation. In case the non-US financial institutions do not enter a QI agreement with the IRS, the institution should provided required tax certifications on a case-by-case basis.

[14]The limitation of benefits provision in tax treaties which the US concluded since 1981 typically provides that certain tax treaty benefits such as reduced withholding rates will not apply to a corporation established in a treaty partner country if more than a specified percent of its stock is held by residents of countries other the US and its treaty partner country. An example is shown in paragraph 20 of the Commentary on Art. 1 of the OECD MTC.

issue is the question of how to apply tax treaty benefits to hybrid entities.[15] A hybrid entity is one that is characterized as a corporation in one jurisdiction and as a transparent entity in another. The existence of a hybrid entity may lead to denying tax treaty benefits to legitimate residents of a treaty partner or cross-border arbitrage.[16] For example, if a partnership is treated as fiscally transparent in a country, the partnership is not liable for tax in that country within the meaning of Art. 4(1) of the OECD MTC. Accordingly, tax treaty benefits will not apply to the partnership itself even if its partners are all eligible residents of the country.[17] On the other hand, in the case that State A, where a partnership was established, treats the partnership as a taxable entity, while State B, where a partner of the partnership is a resident, treats the partnership as fiscally transparent, a source country may not impose taxation which is inconsistent with the terms of either applicable tax treaty with State A or State B. It is desirable to include special provisions in a tax treaty to deal with situations caused by a hybrid entity.[18] If not, a law or regulations[19] should provide guidance to taxpayers.

3.3 Exchange of Information

Now that some ninety jurisdictions have committed to comply with the Global Forum's Standards of Transparency and Exchange of Information for Tax Purposes (Global Forum Standards), enacting legislation necessary to implement the Global Forum Standards is becoming more important. Key issues to be considered in preparing the legislation are:

Confidentiality of received information

Reciprocal exchange of information is possible only if each administration is assured that the other administration will treat received information with proper confidence.[20] The confidentiality rule and penalty in case of breach of confidentiality should be applied in the same manner as they are to information obtained under the domestic laws. Where the current laws on confidentiality of tax information can be construed to apply to information obtained under tax treaties, the authorities should remind tax officials of the importance of confidentiality in information exchange.

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[15]The OECD report, *"The Application of the OECD Model Tax Convention to Partnerships"* (1999) and Commentary on Art. 1 of the OECD MTC explain the issue in details.

[16]See Gustafson et al at p. 234

[17]In this case, the partners should be entitled to tax treaty benefits with respect to their share of the income of the partnership. Para. 5 of the Commentary on Art. 1 of the OECD MTC.

[18]While the partnership may claim the benefit of the treaty between state A and the source country, the partner who is resident of state B may claim the benefits of the treaty between state B and the source country to the extent that the partnership's income is allocated to him/her. Para. 6.5 of the commentary on Art. 1 of the OECD MTC. Art. 4(6) of the 2003 Japan-US tax treaty.

[19]The US provides detailed guidance on how to apply tax treaty benefits to a hybrid entity in Sec. 894 of the IRC and related Treasury regulations.

[20]Para. 11 of the Commentary on Art. 26 of the OECD MTC.

Domestic tax interest

Information gathering measures[21] such as investigative powers by tax authorities are provided by laws for levying their domestic taxes. There may be a case in which a treaty partner requests information that the requested authority does not need for their own tax purposes. For example, a treaty partner country may request information on a transaction between a resident of the requesting country and one in the requested country. If the resident of the requested country reported a huge amount of loss, the tax authority in the requested country may have no need to conduct an audit for their own tax purposes. In this example, the requested authority has to use information gathering measures without "domestic tax interest" in order to provide information to the requesting authority. The tax authorities' abilities to use information gathering measures regardless of domestic tax interest underpin timely and reciprocal exchange of information. In a country where treaties prevail over domestic laws, it can be construed that a provision equivalent to Art. 26(4) of the OECD MTC and the existing domestic laws would allow tax authorities to use information gathering measures regardless of domestic tax interest. However, considering the possible argument by a taxpayer on the admissibility of information provided by treaty partners at court, it is recommendable to include a provision that explicitly allows tax authorities to use information gathering measures solely to provide information to treaty partners.

Criminal cases

Art. 26 of the OECD MTC permits exchange of information on all tax matters including criminal tax cases.[22] Exchange of information for criminal matters can also be based on treaties on mutual legal assistance. In a country where a treaty on mutual legal assistance has been the only instrument for the exchange of information on criminal tax matters, it may be desirable to clarify in a law that tax authorities can use information gathering measures to provide information on criminal tax matters under a tax treaty.

Bank secrecy

While in some countries, banks and other financial institutions are required to protect the confidentiality of financial affairs of their clients even from tax authorities, the Global Forum Standards do not allow the requested country to decline to provide information because of the bank secrecy obligation.[23] Thus, all countries that have committed to the Global Forum Standards are required to change their laws, which are non-tax laws in most countries, so

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[21]Information gathering measures mean laws and administrative or judicial measures. Para. 19.7 of the Commentary on Art. 26 of the OECD MTC.

[22]Para. 5 of the Commentary on Art. 26 of the OECD MTC. Art. 1 of the OECD Model Agreement on Exchange of Information on Tax Matters (OECD Model Agreement) provides that the competent authorities shall provide information that is foreseeably relevant to prosecution of tax matters.

[23]Art. 26(5) of the OECD MTC and Art. 5(4) of the OECD Model Agreement. These paragraphs also provide that tax authorities should not decline to provide information held by nominees, agents, fiduciaries and ownership information.

that tax authorities can have access to clients' information held by banks and other financial institutions.

3.4 Assistance in the Collection of Taxes

Art. 27 of the OECD MTC provides for mutual assistance in the collection of taxes. Whether a country chose comprehensive collection assistance or a limited type of collection assistance,[24] any revenue claim requested shall be collected by the requested country in accordance with the provisions of the laws governing the enforcement and collection of its own taxes, as if the revenue claim were a revenue claim of the requested country.[25] To implement this provision, it is desirable that laws on collection of revenue claims be changed to clarify that the same procedures will apply to a revenue claim requested by treaty partners. It is also desirable that more detailed rules such as the priority order between a revenue claim of the requested country and one of the requesting country be provided by laws or regulations, unless the existing laws on collection of taxes provide applicable rules without ambiguity.

3.5 Mutual Agreement Procedures

As Art. 25 of the OECD MTC provides,[26] an agreement between competent authorities, which resolves taxation which is not in accordance with the treaty, should be implemented notwithstanding any time limits in the domestic laws. While this waiver of time limit is explicit, it would be desirable if tax laws or regulations provided detailed rules on how to implement the agreement and necessary procedures to be taken by taxpayers. The statutory limitation of assessment including refund often corresponds to the period that taxpayers and tax authorities are required to keep relevant documents under domestic laws. Furthermore, it is often the case that competent authorities reach an agreement far later than the statutory limitation of assessment in actual mutual agreement procedures on transfer pricing cases. Given these facts, it would be practically important that laws or administrative guidelines require at least tax authorities to keep relevant documents once a taxpayer presented a case for mutual agreement procedures to competent authorities.

A taxpayer may present a case irrespective of the remedies provided by domestic laws.[27] Nevertheless, a taxpayer often lodges a case to administrative tribunals or courts in parallel with presenting a case to competent authority, in case competent authorities fail to reach an agreement or the taxpayer is not content with the agreement, because laws on appeal or litigation normally provide time limits for lodging a case which are shorter than the period[28]

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[24]Art. 27 of the OECD MTC provides for comprehensive collection assistance. An example of a more limited type of collection assistance is in para. 2 of the Commentary on Art. 27 of the OECD MTC.

[25]Art. 27(3) of the OECD MTC.

[26]Para. 2.

[27]Art. 25(2) of the OECD MTC.

[28]The duration for competent authorities to reach an agreement may differ by a case and by a country. However, Art. 25(5) of the OECD MTC, which allows a taxpayer to submit a case to arbitration if the competent authorities

that mutual agreement procedures usually need to reach an agreement. This parallel process may cause a case in which appeal tribunal decisions or court decisions contradict or overlap with agreements between competent authorities. While it is beyond all disputes that a taxpayer should be relieved from taxation which is not in accordance with either a tax treaty or domestic laws, it should be noted that such parallel pursuit of remedy measures would incur considerable expenses not only for taxpayers but also for tax authorities and judicial bodies.

Thus, it would be desirable that either the mutual agreement procedures or the domestic remedy process be suspended upon a taxpayer's request until the other remedy measure produces a result, in the case that a taxpayer lodges requests for both remedy measures. In the case that a taxpayer wants both remedy measures to proceed in parallel, the taxpayer's decision should be respected, because a taxpayer has the right to present a case irrespective of the remedies provided by domestic laws.

4. Role of Domestic Laws to Counter Tax Treaty Shopping

Treaty shopping can be defined as the exploitation of tax treaty benefits by taxpayers who have little or no relationship with the treaty partner except as shareholders in corporations organized therein.[29]

Art. 31 of VCLT provides that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." Considering that one of the purposes of tax treaties is the prevention of fiscal evasion, transactions conducted to obtain unintended benefits under tax treaties may be construed as the abuse of the tax treaty and tax treaty benefits should not be granted.[30] Furthermore, there are various anti-treaty shopping provisions in tax treaties such as the "beneficial owner" concept, "general bona fide" provision, "activity" provision, "amount of tax" provision, "stock exchange" provision, "limitation of benefits" provision, and provisions aimed at specific tax regime or type of income.[31] Unless transactions meet the requirements set out in these provisions, tax treaty benefits will not be granted.

The question is how anti-abuse provisions in tax laws or case laws such as a general anti-avoidance rule can be applied to a tax treaty shopping case where the treaty has no effective anti-treaty shopping provisions. In the majority of the OECD member countries, such provisions or case laws apply to a tax treaty shopping case on the basis that taxes are ultimately imposed through the provisions of domestic law and therefore, the abuse of tax treaty

are unable to reach an agreement within two years from the presentation of the case to the competent authority, would be indicative.

[29]There are different modes of tax treaty shopping as explained in para. 9 of the Commentary on Art. 1 of the OECD MTC.

[30]Para. 9.3 of the Commentary on Art. 1 of the OECD MTC.

[31]Para. 7-26 of the Commentary on Art. 1 of the OECD MTC.

provisions can also be regarded as the abuse of domestic tax law provisions or jurisprudence rules.[32] Thus, the anti-avoidance rules in domestic laws and case laws do not conflict with the provisions of tax treaties.

It should be kept in mind, however, that the denial of tax treaty benefits in the case of treaty shopping ultimately depends on court decisions or mutual agreement procedures. In addition to the role of anti-avoidance rules in domestic laws, the procedures provided by domestic laws could have deterrent effects on a tax treaty shopping case.

For example, a certificate of residence issued by tax authorities of a country where a taxpayer claiming tax treaty benefits lives could make illegitimate residents hesitate to apply for treaty benefits. A certificate of residence also alerts the tax authorities that the taxpayer has foreign-source income.

The Japanese withholding tax system on artiste companies[33] is another example of how procedures could act to deter tax treaty shopping or tax treaty abuse while allowing legitimate residents of treaty partners to enjoy tax treaty benefits. Where remuneration for the performance of an entertainer or sportsman is not paid to the entertainer or sportsman himself but to another person such as an artiste company, unless a tax treaty has a special provision to tax remuneration whether or not such income is attributable to a permanent establishment, a source country normally cannot tax the remuneration.[34] On the other hand, income paid to the entertainer or sportsman by the artiste company is taxable in the source country and the income recipient is required to file a tax return and pay tax to the source country. However, experience in tax authorities shows that it is unlikely that non-residents will file a tax return unless tax has already been withheld. The Japanese system proceeds by, (i) requiring a payer of remuneration to withhold 15% of payment to an artiste company, then, (ii) requiring the artiste company to withhold 20% of remuneration paid to an entertainer or sportsman and pay the withheld tax to a source country (Japan), and, finally, (iii) allowing the artiste company to claim a refund of tax withheld by the payer. Thus, Japan can collect tax from an entertainer or sportsman without harming tax treaty benefits given to an artiste company.

In designing a procedure that could have deterrent effects on a tax treaty shopping case, tax policy departments should be mindful that imposing an unduly heavy burden on taxpayers or withholding agents may ruin the objectives of tax treaties, i.e. to promote international trade and investment between treaty partners.

[32]Para. 9.2 of the Commentary on Art. 1 of the OECD MTC.

[33]Art. 42(3) of the Special Taxation Measures Law.

[34]Art. 17(2) of the OECD MTC is one of the examples.

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