UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# Double taxation treaties and their implications for investment: what investment policymakers need to know

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# PREFACE

The UNCTAD Division on Investment and Enterprise is the focal point within the United Nations system for all issues related to investment and enterprise development. It conducts cutting-edge policy analysis, provides technical assistance, and builds international consensus on investment and enterprise. The Division takes a lead role in advancing solutions to the development challenges faced by the international community in this area and is dedicated to support investment in sustainable development with its investment and enterprise policy toolkits. Since the launch of the Investment Policy Framework for Sustainable Development in 2012 (updated in 2015), UNCTAD has been at the forefront of efforts to reform the international investment regime and has provided valuable backstopping to this process.

Building on UNCTAD's long-standing expertise on FDI, investment policymaking and international investment agreements, this guide on double taxation treaties (DTTs) and their implications for investment policymakers complements the guide on international investment agreements and their implications for tax measures published in 2021 by UNCTAD in cooperation with the WU Global Tax Policy Center. It also aims to stimulate interaction between investment policymakers and DTT negotiators.

This guide assesses the most relevant DTT provisions and their implications for investment using the Model Conventions of the United Nations and of the Organisation for Economic Co-operation and Development (OECD) as a basis. It provides guidance to investment policymakers on the working of DTT provisions, the proposed changes to DTTs following the OECD/G20 Base Erosion and Profit Shifting project and the implications of those changes for investment. It also draws on UNCTAD's previous work on the impact of the global minimum tax on foreign direct investment, in the World Investment Report 2022 (UNCTAD, 2022) and the taxation paper in the UNCTAD Series on Issues in International Investment Agreements (UNCTAD, 2000).

# EXECUTIVE SUMMARY: WHAT INVESTMENT POLICYMAKERS NEED TO KNOW ABOUT DTTS

Double taxation treaties (DTTs) are international agreements, almost exclusively concluded on a bilateral basis, that aim to alleviate double taxation arising from cross-border business activities. They do so by distributing taxing rights over different items of income or capital between the contracting States. At the same time, DTTs aim to prevent instances of their improper use for the purpose of tax evasion and avoidance. They are the central pillars of international tax coordination and despite their bilateral nature and divergent details, they all follow the same overall patterns determined by model conventions put forward by the United Nations and the Organisation for Economic Co-operation and Development (OECD).

The overarching goal of DTTs is to facilitate cross-border business activities, trade and investment, by preventing the double taxation that such activities might be subject to, while creating a level playing field. Given the material impact that DTTs can have on investment, it is important that investment policymakers understand their main features and are able to engage in debates related to different DTT policy options.

This guide focuses on the most relevant features of DTTs. It revolves around what investment policymakers need to know about the different DTT design options, considering their investment implications. By doing so, it also aims to stimulate interaction between investment and tax policymakers. Alongside the guide on international investment agreements (IIAs) and tax measures (UNCTAD, 2021), this guide aims to allow the two communities to share expertise and ensure more coherent approaches to tax and investment policymaking with a focus on reformed options.

## Personal scope of DTTs

An individual or legal person who is a resident in one or both contracting States may have access to DTT benefits. These conditions leave room for opportunities of jurisdiction shopping and allocation distortions. The international tax system has developed several tools to counter abusive practices at both the domestic and the DTT level. The anti-avoidance rules vary in complexity. Although more complex rules provide greater legal certainty for investors, they are more difficult to administer by tax authorities, which can be a challenge for jurisdictions with limited administrative capacity.

## Taxes covered

DTTs generally cover direct taxes on income and capital. They do not cover indirect taxes or levies that are not considered taxes in the strict sense, such as social security contributions. Some types of levies, such as digital services taxes, may be specifically designed in a way that leaves them outside the scope of DTTs. The vast majority of DTT provisions, including those on relief from double taxation, only apply with respect to covered taxes. Finally, the international tax system leaves a legal vacuum with respect to the coordination of value added tax (VAT), one that could be filled by regional economic integration organizations.

## Attribution of taxing rights over active business income

DTTs attribute taxing rights over active business income to the residence jurisdiction unless the enterprise has a physical presence (a permanent establishment) in the source jurisdiction. The physical presence test makes it possible for an online business to trade with or do significant business in a country without triggering compliance obligations for corporate income tax purposes, which is important from a trade and

investment policy perspective. When deciding on the scope of the definition of a permanent establishment, it is important to keep in mind that the broader the criteria (i.e. the easier it is to trigger the permanent establishment threshold), the more foreign investors will be affected, including smaller ones. Hence, while the broadest possible definition may be appealing from a tax revenue perspective, it must be balanced against its investment implications. Certain types of business activities may not take place in a jurisdiction if they trigger a permanent establishment and the concomitant compliance costs outweigh the business rationale.

## Attribution of taxing rights over passive business income

DTTs allow source jurisdictions to tax passive business income derived from dividends, interests, and royalties under certain circumstances even where the enterprise has no permanent establishment in its territory. The tax is generally levied on a gross basis, by means of a withholding tax (WHT), and up to the amount of a cap established under the applicable DTT. The residence State can then also tax the income but must alleviate any double taxation that arises. WHT is collected by the payer, acting as a withholding agent, simplifying tax enforcement for non-residents. WHTs are, thus, a convenient way for source countries to raise revenue, and they are easy to administer. The application of a gross basis WHT may have some distorting effects in certain situations as it may represent an entry barrier or lead to taxation of loss-making entities. WHT rates vary across DTTs, creating incentives for treaty shopping.

## Attribution of taxing rights over personal income

DTTs attribute the taxing rights over personal income exclusively to the State of residence of the worker or self-employed person, unless the individual has a significant physical presence in the source State. These rules were developed before the spread of mobile and remote working. In the context of remote working, they can lead to a misalignment between where taxing rights are attributed and where the proceeds of work are enjoyed. Remote working arrangements allow firms access to foreign labour without the need to invest in an overseas jurisdiction. Such arrangements also allow firms to rely on independent rather than employed workers and to pass foreign tax and social security responsibilities on to the self-employed. Trade and investment policymakers should be aware of taxing rights applicable to remote working arrangements.

## Methods for elimination of double taxation

DTTs either exclusively attribute taxing rights to one of the contracting States or they provide both States with the possibility to tax, and the State of residence is obliged to provide relief from double taxation. This relief takes the form of either the exemption of the foreign income from the domestic tax base or a credit for the taxes paid abroad. The policy choice depends on whether the State in question wishes to ensure neutrality in the source State where the investment is located (exemption method) or in the residence State of the investor (credit method). From an investment policy perspective this choice can have important consequences as it affects, among others, the treatment of foreign tax incentives.

## Anti-abuse provisions

DTTs include anti-abuse provisions to curb treaty shopping and tax avoidance arising from the improper use of tax treaties. States have three options: (i) a principal purpose test (PPT) provision, (ii) a combination of a PPT provision and a limitation of benefits (LoB) rule or (iii) an LoB provision together with a rule against conduit arrangements. These rules were implemented as a result of the OECD/G20 Base Erosion and Profit Shifting Project and are treated as minimum standards. The choice of one of the three anti-abuse options depends on the contracting States' perceptions of their needs and bargaining positions. The PPT is simpler to implement but may give tax authorities a greater deal of discretion, which brings uncertainty

to taxpayers. An LoB clause provides more predictability and legal certainty to taxpayers, but it is more complex and may present challenges for tax administrations that have capacity constraints.

## Non-discrimination

DTTs provide for non-discriminatory treatment in specified scenarios. Investment policymakers should take note of the key differences between non-discrimination in DTTs and the concept of discrimination in international trade and investment agreements. Most importantly, the non-discrimination provision in a DTT applies on the basis of residence whereas in investment and trade agreements such provisions generally apply on the basis of nationality, leading to a potential mismatch between the different types of treaties.

## Dispute resolution

DTTs contain a system for dispute settlement that differs from the investor–State dispute settlement mechanism used in IIAs. In tax disputes under DTTs, taxpayers are never direct participants in the international resolution of disputes. Existing DTTs predominantly rely on the mutual agreement procedure (MAP) to resolve tax disputes between competent authorities on a best-efforts basis. The MAP is usually time consuming and requires significant administrative capacity on the part of competent authorities. Such capacity is often lacking, especially in countries with limited resources. In some instances, providing for arbitration between the competent authorities as a prolongation of the MAP can make the procedure more effective because competent authorities have a greater incentive to reach an agreement to avoid escalating the matter to arbitration. However, where the MAP fails due to limited administrative capacity, arbitration will do little to improve the situation. In addition, many developing countries do not have confidence in the arbitration process. The United Nations has tried to address this in its DTT model by providing greater flexibility in implementing outcomes, placing caps on costs, encouraging greater transparency in the proceedings and appointing arbitrators familiar with the situation in developing countries. The key to moving forward is to give a greater voice to developing countries in the design of dispute settlement provisions and to provide for more capacity-building.

## Exchange of information

DTTs include exchange of information provisions that require competent authorities (typically the tax authorities of each contracting State) to exchange information where this is relevant to applying the provisions of the DTT or to administering or enforcing the domestic tax laws of either State. Although there is consensus on the importance of these provisions, the administrative aspects of exchange of information continue to be an area of concern, especially in developing countries. The building of technical capacity is a fundamental aspect of reform.

# INTRODUCTION

Double taxation treaties (DTTs) are agreements entered into by two or more jurisdictions to, primarily, avoid international juridical double taxation of income and capital. Such taxation arises where comparable taxes are imposed in two or more jurisdictions on the same taxpayer in respect of the same income or capital and for identical periods. Double taxation can hinder the exchange of goods and services, and the movement of capital, technology and persons. The obstacles it presents can hamper investment. To avoid this, governments typically adopt unilateral measures to provide relief for taxpayers in national laws. This is done by either exempting foreign-earned income from taxation or by providing a credit for the taxes paid abroad. Two jurisdictions with significant ongoing cross-border trade and investment may opt to conclude a DTT that provides the terms for eliminating double taxation.

The rules of a typical DTT provide two ways of eliminating double taxation. One is by allocating the taxing rights to a single jurisdiction – this will determine the contracting State that will have the sole right to tax a category of income or capital. The other is an allocation rule, which may identify that both contracting States have a right to tax the income and, where double taxation arises, one jurisdiction is required to provide relief (by exemption or credit).

International efforts to reduce the occurrence of double taxation are part of the international economic law framework that governs the flow of international goods and services, investment and transfers of technology. DTTs aim to prevent discriminatory treatment of taxpayers, increase certainty regarding the tax implications of an investment decision and manage the resolution of disputes related to double taxation between the contracting States. DTTs have additional tax-specific goals. These include the prevention of non-compliance, tackling tax avoidance and evasion, as well as improving cooperation between tax authorities by providing for the exchange of tax information and mutual assistance in tax collection.

A DTT is ordinarily structured as follows:

Title: identifies the contracting States and may refer to the elimination of double taxation and the prevention of tax avoidance and evasion.

- Preamble: identifies the objectives of the contracting States concluding the treaty.
- Chapter I – Scope of the convention: determines the persons covered (residents of either contracting State) and the taxes covered (taxes on income and capital).
- Chapter II – Definitions of key terms.
- Chapter III – Taxation of income: assigns, with regard to different classes of income, the right to tax to each contracting State depending on whether a taxpayer resides in or has sourced income from that jurisdiction.
- Chapter IV – Taxation of capital: assigns, with regard to different classes of capital, to each State the right to tax depending on whether a taxpayer resides in or has sourced income from that jurisdiction.
- Chapter V – Methods for the elimination of double taxation: designates the use of either the exemption or the credit method.
- Chapter VI – Special provisions: covers treaty clauses on the prevention of discrimination, dispute resolution, exchange of information (EOI) and mutual assistance in the collection of taxes.

DTTs have a long-established history, with the first treaty concluded between Prussia and Saxony in 1869. International cooperative efforts on the design of model rules formally began at the League of Nations in the 1920s (League of Nations, 1925). Since then, a number of international and regional organizations have engaged in developing and evaluating model rules. Examples include the Organization for Economic Co-operation and Development (OECD), the United Nations Committee of Experts on International Cooperation in Tax Matters (UNTC), the African Tax Administration Forum, the European Union and the Inter-American Center of Tax Administrations (CIAT), among others. The two leading model tax conventions (MTCs) utilized by countries are those designed by the OECD and the UNTC, respectively (OECD, 2017a; UN DESA, 2021). Their overall structure is highly similar and the most important difference between the

two models is that the UN MTC seeks to cater more strongly to source countries, which largely aligns with the needs of developing economies.

The model rules have been subject to ongoing revisions triggered by globalization, changes in business and investment practices and to respond to common schemes to avoid or evade the payment of taxes. Importantly, both MTCs contain detailed guidance on the application of their rules in the form of commentaries. The commentaries are frequently relied on by tax authorities, taxpayers, and courts in interpreting DTTs. At times, the interpretations they propose are updated without revisions of the texts of the MTCs themselves.

# 1. THE REFORM OF DTTS – BEPS AND BEYOND

Over the last decade, key provisions of model DTTs have experienced significant reforms. The economic impact and domestic revenue pressures of the 2007/2008 global financial crisis raised public concern about the tax compliance of multinational enterprises (MNEs). In the years following the crisis, as the financial recovery faced obstacles, the complex schemes used to engage in either tax evasion or aggressive tax avoidance came to the forefront.[1] In response to public outcry, in 2012, the G20 reiterated the need to prevent tax base erosion and profit shifting (BEPS) and supported the work of the OECD on this issue (G20, 2012). BEPS refers to “tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax” (OECD, 2023a).

At the request of the G20, the OECD published the Action Plan on BEPS in July 2013, stipulating 15 actions to comprehensively address BEPS (OECD, 2013). The plan identified tax treaty abuse, particularly treaty shopping, as one of the most important sources of BEPS concerns. The individual reports on the different actions gave rise to key proposals for the amendment of specified sections of DTTs. To support the simultaneous reform of thousands of tax treaties, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS was developed. Throughout the course of this guide, reference will be made to pre-BEPS and post-BEPS DTTs as a representation of the changes following the finalization of the work done by the OECD.

It is important for investment policymakers to know that the elimination of double taxation by one State is generally based on the understanding that this income is taxable in the other State. The impacts of and response to BEPS also highlighted major concerns about the role of tax havens and preferential tax regimes in this respect. If the other contracting State levies no or low taxes on income, or there are insignificant flows of cross-border trade and investment between two jurisdictions, the OECD and the UN MTCs encourage governments to reconsider whether there is a risk of double taxation and whether it justifies entering into a DTT with that State.

Policymakers should additionally consider the elements of the other State’s tax system that may increase the risk of non-taxation. A variety of tax incentive programmes may qualify as harmful, including some special economic zones (SEZs), international financial centres, special software and intellectual property regimes, innovation hubs and/or boxes, patent boxes and shipping regimes (OECD, 2019). More generally, the OECD’s work on harmful tax competition identified that regimes with no transparency, a lack of EOI, low or no taxes on income, and no substantial activities could give rise to harmful outcomes such as facilitating tax avoidance (OECD, 1998a). This work gave rise to the Forum on Harmful Tax Practices, which peer reviews tax regimes. Investment policymakers should be aware of this process, as its outcomes can lead to the requirement to eliminate or redesign their tax regimes.

[1] For instance, see Shaxson, N. and J. Christensen (2008). Not on My Watch Please. Tax Justice Network, Tax Justice Focus Quarterly Newsletter, The Research Edition, Vol. 4 (2). Available at https://www.taxjustice.net/cms/upload/pdf/TJF_4-2_AABA_-_Research.pdf.

# 2. INTERACTION BETWEEN DTTS AND INVESTMENT POLICY

IIA and DTT networks are among the most extensive treaty networks worldwide, with more than 2,500 IIAs and over 3,000 DTTs currently in force (UNCTAD, 2023; Lang et al., 2017). The shared objectives of both frameworks are to provide certainty and protection to investors, raise investment attractiveness and promote cross-border investment. They aim to function as tools for promoting and advancing international economic relationships (UNECA, 2020).

Key differences exist between IIAs and DTTs. As specialized treaties, DTTs provide investors with rules regarding the tax treatment of their investments whereas IIAs are far broader in scope. DTTs and IIAs are designed and negotiated under different institutional frameworks. The Ministry of Finance takes the lead on tax treaties, whereas national investment promotion agencies and ministries of Trade, Industry, Investment, Finance or Foreign Affairs will usually guide the way for IIAs (Choudhury and Owens, 2014). This often means that the key public officials involved in concluding IIAs and DTTs do not interact. DTTs are based on models such as those developed by the OECD and the United Nations, whereas IIAs, despite their similar structure, do not follow a universal model. Lastly, the rules of a DTT are applied and implemented on an ongoing basis as investors determine and pay their tax liability, whereas the standards of protection available in IIAs become most relevant when a treaty breach is alleged by a foreign investor.

The UNCTAD guide on IIAs for tax policymakers points out that IIAs interact with DTTs and have important implications for tax policymaking (UNCTAD, 2021). It identifies the following key interactions:

Since most IIAs do not exclude taxation from their substantive scope, tax measures of general or specific application – including those falling within the ambit of a DTT – may be covered by an IIA and could be challenged through investor–State arbitration proceedings known as investor–State dispute settlement (ISDS).

Most IIAs are silent on their relationship with DTTs and only few IIAs provide for special mechanisms to address tax-related claims brought on the basis of IIAs.

Some terms and concepts used in DTTs resemble those adopted in IIAs. However, they may have different implications. For instance, it is standard practice that the non-discrimination provision in DTTs permits differential tax treatment of resident and non-resident taxpayers. Non-discrimination provisions in IIAs are rarely explicit on this point.

DTTs typically do not include most-favoured-nation (MFN) clauses because they are generally based on the principle of reciprocity and thus both parties should make concessions. By contrast, IIAs virtually always provide for MFN treatment. Generally, IIAs exclude DTT benefits in one way or another from the scope of the MFN provision. However, where no tax carve-out is included, the MFN provisions in IIAs could potentially be used to claim the favourable treatment contained in a DTT between the host State and a third party. This can make the DTT less effective in preventing tax avoidance and evasion.

There are shared concerns about the use of unreformed IIAs and DTTs as they often allow treaty shopping, nationality planning or the establishment of mailbox companies, to enjoy the benefits of a treaty. More recent, reformed IIAs may include a denial-of-benefits clause and circumscribe the types of covered investors to ensure that only investors with substantial business activities in the other contracting party can access treaty protections. Anti-abuse rules in DTTs aim to achieve similar goals. Here UNCTAD has highlighted the opportunities for cross-regime learning and shared solutions between the two communities (UNCTAD, 2021).

Given the overlapping interests, issues and objectives of DTTs and IIAs, it is important that the ongoing reform efforts in both areas of policymaking are designed and implemented in a complementary manner. This recommendation extends to the investment-attraction policies designed by investment authorities.

Synergy between both types of policies is also important to limit the incidence of forum shopping by taxpayers.

This guide on DTTs for investment policymakers aims to support the mutual supportiveness between both fields of policymaking, encouraging reforms in international investment governance and advancing sustainable development objectives. It complements the guide for tax policymakers on IIAs and their implications for tax measures (UNCTAD, 2021). It identifies the most important DTT provisions that have implications for investment policymaking:

- Preamble
- Scope of DTTs
- Permanent establishments
- Allocation rules
- Methods for elimination of double taxation
- Anti-abuse provisions
- Non-discrimination
- Dispute resolution
- Exchange of information

For each of these provisions, this guide sets out the implications of the pre-BEPS version. It then introduces the reform options and implications of the OECD/G20 BEPS Project proposals and makes reference to the United Nations recommendations.

# SELECTED DTT PROVISIONS AND THEIR IMPACT ON INVESTMENT

Pre-BEPS double taxation treaties (DTTs) were characterized by a conventional approach, seeking to prevent double taxation by defining key terms, assigning and dividing taxing rights between the country of residence and the source country and including a number of special provisions such as on the diplomatic settlement of disputes through the Mutual Agreement Procedure (MAP). Post-BEPS DTTs are designed to adapt to the changing global economy and feature innovative provisions to prevent treaty abuse, address modern business models and enhance dispute settlement. Reformed DTTs aim to prevent double taxation while limiting the frequency of non-taxation. They thereby seek to regulate the taxation of cross-border economic activities in a shifting business landscape.

# 1. PREAMBLE

The preamble sets out that DTTs do not intend to create opportunities for double non-taxation.

## What investment policymakers need to know about the preamble

Before BEPS, the OECD and UN MTCs did not contain a preamble. Individual States could, however, include one in their treaties. Following the OECD/G20 BEPS project proposals, the OECD and UN MTCs were amended to include a preamble that expressly provides that DTTs are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. The new preamble thus clarifies that the object and purpose of tax treaties is not to generate double non-taxation. It also serves as a part of the context within which courts will interpret ambiguous terms of DTTs.

The preamble to the OECD and UN MTCs was included in 2017 following recommendations in the BEPS Action 6 Final Report. The intention was to expressly recognize that the purpose of tax treaties is the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Given the BEPS risks raised by treaty shopping, the preamble expressly mentions that tax treaties should not result in tax avoidance through treaty-shopping arrangements. Previously, this was only done in the commentaries, not the text of the MTCs themselves.

Under the 1969 Vienna Convention on the Law of Treaties, a treaty is interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose. The preamble plays two roles in this respect. First, it forms part of the context of the treaty. Second, it lays out the object and purpose of the treaty as agreed between the contracting States. The preamble, thus, supports the interpretation of ambiguous treaty terms. In effect it guides the interpreter in finding the ordinary meaning of DTT terms that best reflects the intentions of the parties. It cannot, however, create, undermine, or change treaty obligations included in the substantive rules. For instance, although the preamble states that the objective of DTTs is to prevent non-taxation, this statement does not create new anti-abuse rules on its own and can only guide the interpretation of existing rules.

**Table 1. Post-BEPS approach frequently used in DTTs**

| Reform options | General implications |
|---|---|
| Clarify in the preamble that the purpose of tax treaties is the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping). | The preamble is not an anti-abuse provision in itself but forms the context that supports the interpretation of ambiguous tax treaty terms.<br><br>By clearly stating that DTTs do not aim to create opportunities for non-taxation, interpreters are guided in attributing meaning to ambiguous terms in the operative part of the treaty. |

*Source:* UNCTAD.

# 2. PERSONAL SCOPE

The personal scope of the DTT determines what individuals and non-individuals are covered by the treaty's provisions.

Both pre-BEPS and post-BEPS MTCs provide that DTTs shall apply to "persons" who are "residents" of one or both contracting States. Persons can be natural or legal persons, including unincorporated societies or associations. Residents, defined in Article 4 of the MTCs, are persons who are liable to tax in a jurisdiction by reason of their domicile, residence, place of management or other similar criterion. Post-BEPS, additional provisions were included on the treatment of income earned by fiscally transparent entities and the right of contracting States to tax their own residents. This additional guidance was intended to neutralize mismatches between two jurisdictions in the classification of entities. It provides that income earned by a transparent entity in a contracting State is only to be treated as income of a resident to the extent that it is treated as such in the that State. For investors this means that investment structures that have fiscally transparent entities may be denied treaty benefits if the persons behind the transparent entity and liable to tax are not residents of a contracting State. Additionally, the clarification that contracting States have the right to tax their own residents is intended to prevent treaty interpretations used to circumvent domestic anti-abuse rules. Except under specific exemptions, domestic anti-abuse rules are, thus, explicitly in line with DTTs and can be adopted by contracting States.

## A. Persons covered

### What investment policymakers need to know about the pre-BEPS approach to persons covered

To determine who should enjoy treaty benefits, income must be attributable to a person. A person can be an individual, a company and any other body of persons such as partnerships, unincorporated societies or associations (Article 3(1)(a)) of the OECD and UN MTCs). Differing rules at the domestic level make the attribution of income difficult. For instance, some countries treat partnerships as fiscally transparent entities, effectively ignoring the partnership and treating the partners as the taxpayers, liable to tax on their respective income. The existence of disparate treatment is also the case for trusts, for which some countries focus on the legal entitlement (trustee) while others consider the economic entitlement (beneficiaries). Pre-BEPS, the OECD and UN MTCs did not contain specific guidance in the substantive text of the treaty on the treatment of such mismatches. However, the commentaries dealt with the treatment of partnerships that are treated as fiscally transparent. In the absence of specific treaty provisions, taxpayers were able to take advantage of mismatches in the treatment of an entity or an instrument under the laws of two or more jurisdictions to avoid or reduce their taxes (OECD, 2015a).

### Table 2. Pre-BEPS approach frequently used in DTTs

| Approach | General implications |
|---|---|
| To enjoy treaty benefits, a taxpayer must be a "person" who is a "resident" of one or both contracting States. "Person" includes an individual, a company and any other body of persons. | The DTT definition of a person is broad, and a non-exhaustive list is provided. Whether an individual or a non-individual counts as a person is determined on the basis of the domestic law of each tax jurisdiction.<br><br>Though investors could use mismatches to reduce their tax liability, it also means that there may be instances of uncertainty for investors. Clarity on how these mismatches are addressed would therefore be beneficial for investors. Consequently, investment policymakers may consider supporting reforms to provide clarity on hybrid mismatches. |

*Source:* UNCTAD.

## Takeaways for investment policymakers: post-BEPS reform of persons covered

For investment purposes, it is necessary to identify whether the taxpayer satisfies the definition of a "person". The wide definition adopted in the OECD and UN MTCs means that a broad range of entities qualify as "persons". As opposed to pre-BEPS DTTs, which do not make express reference to fiscally transparent entities in their texts, DTTs following the BEPS project clarify how to treat the income of fiscally transparent entities. To mitigate the effects of hybrid mismatches, differences in how two jurisdictions treat the same entity or instrument, Article 1(2) of the MTCs states that income derived by or through fiscally transparent entities shall be treated as income of a resident of a contracting State only to the extent that the income is in fact treated as such in that contracting State. This ensures that treaty benefits such as reduced withholding rates are not granted where neither of the contracting States treats the income of a fiscally transparent entity as income of one of its residents (OECD, 2015a).

The consequence of the BEPS proposal is to limit treaty benefits to income that is attributable to a resident in the contracting State. To illustrate, one can imagine a partnership that is treated as a fiscally transparent entity in one State. The partners that are liable to tax on the income earned by the partnership are residents of that State. Interest income derived by the partnership from the other contracting State will benefit from the reduced withholding tax rates in the DTT. However, if the partners in this scenario are residents of a third State, the interest income would not be taxed at the reduced rate in the DTT. For investors this implies a need to analyse the specific treatment of fiscally transparent entities in the domestic law in their States of operation. Where the persons liable to tax on behalf of the entity are not residents of one of the contracting States, treaty benefits may be denied. For investment policymakers it is equally necessary to be aware that income derived by transparent entities may not profit from treaty benefits if the entities are wholly owned by non-residents.

A second clarification as a result of the BEPS Project relates to domestic anti-abuse provisions. Most of the provisions of DTTs seek to limit the rights of one State to tax residents of the other State. For example, business profits are taxable only in the State of residence of an enterprise unless it has a permanent establishment (see below) in the other State. The argument had been made that some DTT provisions may also restrict States in their ability to tax their own residents, even where this was not intended. Post-BEPS, the MTCs explicitly confirm the right of States to tax their own residents, except in a limited number of circumstances. As a consequence, provisions of domestic law that seek to prevent DTT abuse are difficult to challenge by claiming that the contradict the treaty's provisions.

**Table 3.** Post-BEPS approach frequently used in DTTs

| Reform options | General implication |
|---|---|
| Amend Article 1 to provide that income derived by or through a fiscally transparent entity shall be treated as income of a resident of a contracting State only to the extent that the income is treated as such in that contracting State. | For purposes of fiscally transparent entities, treaty benefits will be afforded only where the persons liable to tax for the income of the entity are residents in one of the contracting States. The aim is to prevent the allocation of benefits in inappropriate circumstances. Investors therefore need to understand the treatment of fiscally transparent entities in their States of operation and determine whether persons liable to tax for income earned by the entity are residents of one of the contracting States. |
| Clarify that the treaty does not affect the taxation by a contracting State of its own residents except with respect to a limited number of provisions of the DTT. | This amendment is intended to expand the principle that contracting States may tax their own residents to most of the provisions of the DTT. It was previously contained only in the commentary to Article 1. This is to avoid instances where provisions aimed at the taxation of non-residents are interpreted in a manner that limits the right of a contracting State to tax its own residents. The amendment makes it difficult to challenge domestic anti-abuse rules on the grounds that they contradict treaty provisions. |

*Source:* UNCTAD.

## B. Tax residency

### i. Liability to tax

#### What investment policymakers need to know about the pre-BEPS approach to liability to tax

Once the "person" requirement is met, the next issue is the residence criterion. Only a taxpayer that is a resident in one or both contracting States can have access to treaty benefits. Taxpayers are residents of one or both contracting States if they are subject to unlimited tax liability (worldwide taxation) triggered by their domicile, residence, place of management or any other criterion of a similar nature (Article 4(1) of the OECD and UN MTCs). For purposes of a DTT, a taxpayer subject to limited tax liability (source taxation) cannot be a resident and gain access to treaty benefits. For example, if an individual resident in a third State has property in one of the contracting States that they rent out, the contracting State where the property is located would likely exercise source taxing rights over the income derived from the property. This, however, does not make the individual a resident of this State for the purposes of benefiting from its DTT network.

DTTs do not define what it means for a person to be "liable to tax". Therefore, a determination of residence requires States to revert to domestic law. The key feature is whether the person is legally "liable to tax" in the State even if in practice they do not pay any tax there. This approach means that fiscally transparent entities are not considered to be "liable to tax" and are, hence, outside the scope of the treaty. Failure to meet the "liable to tax" requirement immediately excludes a person from claiming treaty benefits. At the same time, entities that are "liable to tax" though exempted for one reason or another, such as some non-profit organizations or investors that benefit from tax holidays, would be within the scope of the treaty. Some States, like the United States, have taken the approach that entities that are "liable to tax" are only entitled to treaty benefits if they are actually "subject to tax".

**Table 4. Pre-BEPS approach frequently used in DTTs**

| Approach | General implication |
|---|---|
| Residents of a contracting State are persons liable to tax on a worldwide basis in the contracting State by reason of their domicile, residence, place of management or any other criterion of a similar nature. | A person must be liable to worldwide taxation in the residence State. Liability to tax considers the legal situation as opposed to the actual payment of taxes. Therefore, exempt entities may be able to access treaty benefits as they are still "liable to tax", while fiscally transparent entities would not be liable to tax. Persons that fail to meet this requirement are not afforded treaty benefits.<br><br>From an investment standpoint, it is necessary to consider existing and potential company structures and their interplay with DTT provisions. Entities that enjoy tax exemptions tend to have access to treaty benefits as they are theoretically "liable to tax". From an investment policy perspective, tax-exempt entities as opposed to transparent entities, thus, create different consequences for foreign investors despite the seemingly similar immediate practical result of non-taxation. |

*Source:* UNCTAD.

## Takeaways for investment policymakers: post-BEPS reform of liability to tax

As the requirement to be "liable to tax" does not consider the actual payment of taxes, tax exempt companies such as foreign investors benefiting from a tax holiday meet this requirement and are able to access treaty benefits. This, however, appears to contradict the purpose of DTTs, specifically, the aim not to lead to non-taxation or reduced taxation through tax evasion or avoidance. This is because investors could make use of exempt entities, as opposed to transparent entities, to access treaty benefits while paying little to no tax in their residence State. In this regard, there have been discussions about introducing a stand-alone subject-to-tax rule (STTR) at the OECD, under the two-pillar solution to address the tax challenges arising from the digitalization of the economy, and at the UNTC. The OECD has released detailed guidance on the STTR in October 2023 (OECD, 2023b). The UNTC has equally approved a subcommittee draft text (Committee of Experts on International Cooperation in Tax Matters, 2023). Apart from design differences, with the UN rule being wider in scope, in general both types of STTR allow source States to tax income which is subject to a low level of taxation in the residence State. The impact of such a provision would be that where a source jurisdiction has ceded taxing rights and the resident jurisdiction does not exercise the right at a prescribed minimum level, taxing rights revert to the source State. As stated above, some treaties signed by countries like the United States already deny treaty benefits to an exempt entity if that entity is not actually subject to tax.

For investment policymakers, these amendments have a direct impact on tax incentives for foreign investors. That is, if a country imposes low or no taxes on income, or where companies are given significant exemptions such as tax breaks for specific income, this may trigger additional tax in the source State. Policymakers must therefore follow up with the newly proposed rules and ensure that the investment regimes in their respective countries are aligned with these proposed changes. Where domestic rules lead to no or low taxation, taxing rights under a DTT would revert to the source jurisdiction. This means tax revenue is lost without providing a tax benefit to the investor as initially intended.

**Table 5. Proposed amendments by the UNTC**

| Reform options | General implication |
| --- | --- |
| Introduce an STTR. | The inclusion of an STTR provision in bilateral DTTs or a multilateral instrument could have a significant impact on investment policymaking. Although tax exempt entities would theoretically be "liable to tax" and therefore satisfy the residency requirement, if left unexercised, taxing rights revert to the source State.<br><br>Investment policymakers must therefore consider the implications of this new provision on the tax incentive regimes they operate. This may lead to a shift away from low or no taxation as a means to attract investment. |

*Source:* UNCTAD.

## ii. Dual residency

### What investment policymakers need to know about the pre-BEPS approach to dual residency

A finding of residency is a matter of domestic law, which means that a person may be resident of none, one, or even both contracting States of a DTT. The latter occurs where a person has unlimited tax liability in both States by reason of the criteria set out in Article 4(1) of the MTCs. For example, individuals can have their domicile or a habitual abode that meets residency requirements in multiple States. Similarly, companies may also meet the residence requirements in multiple States, for example, when they are incorporated in one State but have their place of management in another State.

Dual-residence situations are dealt with under explicit tie-breaking rules whose aim is to attribute tax residence to only one of the contracting States for the purposes of applying the allocation rules or to neither State if no agreement can be reached. For individuals, Article 4(2) of the OECD and the UN MTC set out a hierarchical approach to the determination of residency. The article provides a list of criteria to be used, including permanent home, centre of vital interest, habitual abode and nationality. This approach is adopted in both pre-BEPS and post-BEPS MTCs.

For legal persons, pre-BEPS treaties settled dual residency based on the place of effective management (POEM) test. This was the preferred approach for two reasons: it was not a purely formal requirement that could easily be manipulated; and while companies could have many places of management, they could have only one POEM (Bräumann, 2019). The POEM is the place where senior officials make key management and commercial decisions connected to the operations of the entity in question, going beyond mere supervision. Given its fact-based nature, there may be divergences in the domestic interpretation and practical application of the POEM test. As a consequence, two States may be the place of effective management, which defeats the purpose of a tie-breaker rule. Moreover, changing business models make it easy to shift meeting locations. This means that it is increasingly difficult to pinpoint the actual location of effective management.

**Table 6. Pre-BEPS approach frequently used in DTTs**

| Approach | General implication |
|---|---|
| Where an individual is a resident of both States, residency shall be determined based on the following criteria, ordered in sequence of application: the presence of a permanent home, the centre of vital interests, the presence of a habitual abode and nationality. In cases where these do not result in the determination of a single tax jurisdiction, the competent authorities shall determine residency through mutual agreement. | Individuals should consider the criteria set out in Article 4(2) to determine the place of residency for purposes of the treaty allocation rules. |
| Where a non-individual is a resident of both States the POEM test is used to determine residency. | The changing business environment and differing approaches of States make it at times difficult for investors and competent authorities to identify the POEM for the application of the allocation rules. Generally, the POEM is the place where key management and commercial decisions are made. Despite being an autonomous treaty term, domestic approaches to the test differ, leading to uncertainty for investors. Uncertainty can act as a barrier to investment. Therefore, where States opt to include the POEM test as the tie-breaker rule, it may be worth adopting a shared interpretation. |

*Source:* UNCTAD.

## Takeaways for investment policymakers: post-BEPS reform of dual residency of non-individuals

The issues with the POEM test largely resulted from the lack of additional criteria when the test failed to provide satisfactory results. Article 4(3) of the 2017 OECD and UN MTCs were both fundamentally changed following the BEPS Action 6 Final Report by abolishing the test altogether. Though the POEM test is still included as an alternative approach in the OECD MTC Commentary, it should be used only to the extent that countries agree on a shared interpretation of the meaning of a POEM (paragraph 24.5 of the Commentary to Article 4 of the 2017 OECD MC).

In the post-BEPS MTCs, dual residency of non-individuals is dealt with on a case-by-case basis through the MAP. During the MAP, competent authorities are only required to endeavour to reach a resolution, which implies the absence of a binding obligation to do so. Where there is no agreement on a single residence, the non-individual is denied access to treaty benefits. Unlike the previous test in which a single residence State is identified, the post-BEPS approach, hence, envisions instances when there is no single residence for the purposes of the applicable DTT. As a consequence, investors run a risk of satisfying the person and residence requirements, yet do not gain access to treaty benefits.

**Table 7. Post-BEPS approach frequently used in DTTs**

| Reform options | General implication |
|---|---|
| Abolish the POEM test and introduce a new rule which determines residency on a case-by-case basis through the MAP, and where there is no agreement, the non-individual does not gain access to treaty benefits. | Significantly, there is no requirement for competent authorities to come to an agreement and therefore there may be instances in which a non-individual with dual residency is denied access to treaty benefits because of a lack of agreement. Investors are therefore likely to be more cautious with the structures they adopt to avoid triggering dual residency. |

*Source:* UNCTAD.

# 3. SUBSTANTIVE SCOPE: TAXES COVERED

The substantive scope determines what types of taxes are included and excluded from coverage under the DTT.

## What investment policymakers need to know about taxes covered

Article 2 of the OECD and the UN MTCs determines which taxes are covered by DTTs. These are taxes on income, capital and any identically or substantially similar taxes imposed after the signing of the treaty. This includes taxes on total income, total capital or elements thereof, including capital gains tax and employment tax. The provision's broad scope also includes taxes imposed by regional and municipal bodies. Social security contributions and other charges that are imposed in return for a public service or for a revenue-raising objective do not fall within the scope of DTTs. Indirect taxes are also outside the scope of DTTs. A number of treaties provide for a list of covered taxes. The vast majority of DTT provisions only apply with respect to covered taxes.

Article 2 envisions application of the DTT to all income taxes irrespective of how they are levied. There is, however, generally a distinction between taxes on income and taxes on revenue. This distinction has been challenged, and affirmed, in a number of domestic court cases. From an investment standpoint the interpretation of Article 2 is particularly important as it is related to the ability of States to bring about fundamental changes to international taxation through new revenue taxes.

An example of such relatively new taxes are digital services taxes (DSTs). They are generally imposed on gross revenue and considered to be outside the scope of DTTs as they are not computed on net income. While this is not universally accepted, the practical reality is that often for such DSTs no relief from double taxation is available, which may affect investment. In addition, taxpayers may also not receive double tax relief under the domestic tax law of their residence States in respect of DSTs charged abroad. Apart from not being covered by DTTs, other reasons, beyond the scope of this guide, may speak for or against DSTs.[2] Given their potential impact on the investment climate, it is important for investment policymakers to understand their nature and take part in the domestic dialogue on whether or not to introduce and how to design DSTs.

In addition, indirect taxes such as value added tax (VAT) that have a significant impact on cross-border trade are outside the scope of DTTs. Increased trade has led to greater interaction between VAT systems, which increases the risk of both double taxation and non-taxation. These risks are exacerbated by the lack of international VAT coordination. In response to this gap, the OECD released the international VAT/GST guidelines, which "present a set of internationally agreed standards and recommended approaches to address the issues that arise from the uncoordinated application of national VAT systems in the context of international trade" (OECD, 2017b). VAT coordination is currently spearheaded by regional economic integration organizations such as the European Union, which has harmonized intra-EU VAT rules since the 1970s. As global coordination may prove elusive for the time being, regional economic organizations are uniquely positioned to fill the coordination gap.

[2] These include, for example, their imposition on gross revenue, thus, including in the case of loss-making entities; divergent approaches to implementation across jurisdictions, creating compliance costs; their revenue potential; and their interaction with the OECD-led two-pillar solution to address the tax challenges arising from the digitalisation of the economy.

## Table 8. Approach frequently used in DTTs

| Approach | General implication |
| --- | --- |
| DTTs cover taxes on income and capital and any identical or substantially similar taxes imposed after the signing of the treaty. | Only taxes on income and capital are covered by DTTs. In some cases, contracting States include a list of covered taxes. The approach has been that only taxes on net income are covered while taxes on gross revenue are outside the scope of DTTs. No tax treaty relief is available to taxpayers for double taxation with respect to out-of-scope taxes.<br><br>Double taxation arising from out-of-scope taxes may place an unintended burden on investors. Digital services taxes, for example, are a relatively new kind of tax generally imposed on gross revenue and, thus, outside the scope of DTTs. The cross-cutting impact of these taxes presents room for cooperation between tax and investment policymakers to develop a suitable approach to specific tax concerns, including taxation of the digital economy.<br><br>Indirect taxes such as value added tax have a significant impact on cross-border investment. As they are not covered in DTTs, regional blocs may be well positioned to fill the vacuum and work to create a system of VAT coordination. |

*Source:* UNCTAD.

# 4. PERMANENT ESTABLISHMENTS

The definition of a permanent establishment is of crucial importance to the allocation of taxing rights under DTTs.

## What investment policymakers need to know about the pre-BEPS approach to permanent establishments

The definition of a permanent establishment (PE) is one of the core concepts in international taxation. Article 5 of the OECD and UN MTCs provides the conditions for the establishment of a PE in a source State. Generally, a PE requires a physical presence, often for a certain duration. The existence of a PE in the source State means that income generated in that State becomes taxable there. Consequently, a common technique to avoid taxation in the source State is to avoid the creation of a PE. Post-BEPS approaches aim to tackle this problem. More generally, the requirement of a physical presence to attribute taxing rights to the source State is increasingly unsuited to the modern business environment.

Some DTT provisions refer to the concept of a permanent establishment (PE) for the allocation of taxing rights. For example, under Article 7 of the OECD and UN MTCs, business profits of an enterprise are taxable only in the State of residence of the enterprise. This rule applies unless the enterprise has a PE in the source State. In that case, the source State may tax part of the enterprise's profits. Similarly, for Articles 10, 11 and 12, relating to dividends, interest payments and royalties, the existence of a PE in the source State may, depending on the circumstances, be relevant to the allocation of taxing rights. More generally, the existence (or not) of a PE greatly influences which State (source or residence) taxes certain income.

A PE is defined in Article 5 of the OECD and UN MTCs. The basic rule is that it is a "fixed place of business through which the business of an enterprise is wholly or partly carried on" (Article 5(1) MTCs). This includes, for example, a place of management, a branch, an office, a workshop, and a mine (Article 5(2) MTCs). Determining whether there is a fixed place of business involves consideration of the geographical and temporal aspects of the place. The geographical aspect means that the place is fixed in a geographical sense, so that a moving vehicle would not be able to form a PE. The temporal aspect refers to permanence in regard to the period for which the fixed place of business has existed, ordinarily six months.

A building site or construction or installation project establishes a PE where it meets the agreed time threshold; for the OECD MTC it is 12 months, while the UN MTC provides for 6 months. The UN MTC also includes assembly projects and supervisory activities. The time period for a construction PE varies between actual treaties, with some providing for 90 days and others providing for as long as two years (Arnold and Loomer 2023).

A dependent agent can also establish a PE. This is a person who has the authority to conclude contracts on behalf of the enterprise and habitually exercises this authority. Persons acting as independent agents cannot set up a PE for an enterprise. DTTs exclude preparatory and auxiliary activities conducted in the source State through a fixed place of business or a dependent agent from establishing a PE.

Exclusive to the UN MTC but relatively widespread in actual treaty practice (Wijnen and de Goede, 2014), a PE may also be established through the furnishing of services for a specified time in any given 12-month period. Thus, where a foreign enterprise provides, for example, consultancy services without a fixed place of business in the source State, after a sufficiently long period, income from such services

becomes taxable in the source State. There is disagreement between States whether such services must be rendered through a physical presence or become taxable even when provided as remote services.

As can be seen, traditionally, the concept of PE heavily relies on the assumption of a physical presence. The digital economy, including remote business models and digital services, as well as the rise of the economic importance of intangible property rights increasingly challenge the assumed importance of a particular physical location.

| Approach | General implication |
|---|---|
| A PE is established by one of three means:<br>• a fixed place of business through which an enterprise operates;<br>• a building site or construction or installation project that meets the agreed time threshold;<br>• a dependent agent that has the authority and habitually exercises it to conclude contracts on behalf of the enterprise.<br>Preparatory and auxiliary activities conducted through a fixed place of business or a dependent agent do not create a PE. | From an investment standpoint, establishment of a PE is a key element, as it determines whether the source jurisdiction may tax the business profits of an investor. Whether or not the creation of a PE is desirable from the point of view of investors depends on their specific business and tax strategy. For pre-BEPS treaties, PEs can be established through a fixed place of business, a dependent agent and construction projects that meet the time threshold. |
| UN MTC services PE. | A PE may be established in the source State through the furnishing of services. |

*Source:* UNCTAD.

## Takeaways for investment policymakers: post-BEPS reform options

In the past, MNEs at times artificially avoided the establishment of a PE to avoid taxation in the source State. To tackle this, BEPS Action 7 directly addressed the definition of PEs. Its recommendations aim to, for example, mitigate instances of circumventing the establishment of a PE by splitting contracts or fragmenting services. Regarding the splitting of construction contracts, the OECD noted that specific time thresholds were susceptible to abuse. Instead of carrying out a single construction project over the course of, for example, 12 months, MNEs would split the project between different sub-entities that carry out the work. This way, it is possible to avoid PE status as no single entity works on the site for the period required to meet the temporal threshold. The commentaries to the OECD and UN MTCs now recommend that where connected activities are carried out at the same site by closely related parties during different periods of time, these activities are aggregated and treated as one.

Relatedly, there were instances of artificially avoiding the creation of a PE by fragmenting business activities into several small operations. MNEs could then argue that these activities are preparatory and auxiliary to the main business and therefore, when viewed in isolation, not capable of establishing a PE in themselves. However, if viewed holistically, the same activities are complementary operations and part of a larger, cohesive business which would establish a PE in the source State. The post-BEPS approach aims to prevent this type of abuse and may affect how investors structure their global value chains.

Another issue identified under the OECD/G20 BEPS project was the use of so-called commissionaire agreements to avoid dependent agent PE status. In such arrangements, an individual would sell products in their own name, representing a foreign enterprise that owns the products. This allows the enterprise to market its products without creating a PE. The individual making the sales is not taxed on the profits from the sales, as they do not own the products, but rather on the remuneration received for their services. Amendments were included following the BEPS project to tackle this avoidance technique. Articles 5(5)

and (6) now provide that a PE shall be established where a person in the source State habitually plays the principal role leading up to the conclusion of contracts and these contracts are in the name of an enterprise, or for the transfer of ownership of property of that enterprise or for the provision of services by that enterprise. Moreover, where an otherwise independent agent acts exclusively or almost exclusively on behalf of one MNE, a PE is also established. As a consequence, the source State gains taxing rights over the income attributable to the PE, meaning the income arising from the sales.

### Table 10. Post-BEPS approach frequently used in DTTs

| Reform options | General implication |
|---|---|
| Revise the approach to split up construction contracts and aggregate periods of time spent by closely related entities. | This is intended to mitigate the risk of splitting contracts between closely related parties. For investors and policymakers, it is necessary to consider the investment structures adopted by entities. MNEs that split contracts based on specialization of specific entities are likely to be most affected. If the aggregate activities undertaken by the different entities meet the time threshold, a PE is established and income attributable to it is taxable in the source State. |
| Include DTT provisions to tackle the fragmentation of services. | Preparatory or auxiliary services offered in a source State will be considered within the context of all services offered by the entity or entities of the same MNE group to determine whether a PE is established. Investors can therefore form a PE through previously excluded preparatory or auxiliary services if they form part of a cohesive business operation. |
| Extend coverage to dependent agent PEs – no requirement to sign contracts, enough to play principal role leading to the conclusion of contracts.<br><br>Independent agents that act exclusively or almost exclusively for one enterprise can establish PEs in the source State. | Investors operating through commissionaire arrangements or other similar arrangements could trigger PEs in the respective States. Therefore, it is necessary to review structures and identify instances when this may occur. A similar approach should be taken for investors operating through independent agents. Investment policymakers should be aware of circumstances in which PEs are created, to provide adequate guidance on the best operational structures to adopt. |

*Source:* UNCTAD.

# 5. ALLOCATION RULES

The allocation rules of DTTs distribute taxing rights for certain types of income or capital between the two contracting States with the aim of eliminating double taxation.

## What investment policymakers need to know about the pre-BEPS approach to allocation rules

DTTs provide for different allocation rules to determine which contracting State will have taxing rights for a certain item of income or capital. These rules are generally divided into two groups: those that allow taxation in both contracting States, and those that grant exclusive taxing rights to only one State. In the case where a taxing right exists in both States, source State taxation is usually limited to a certain percentage and double taxation is avoided through the application of the method article by the residence State (exemption or credit method). In the case where one State has the exclusive taxing right on certain income or capital, the other State is obliged to refrain from taxing under the DTT. In this case, double taxation is avoided without the need to use the method article. Different types of income such as active business income and passive income, for example, from interest payments, are treated differently with respect to the allocation of taxing rights between the source State and the residence State.

One of the ways by which DTTs eliminate double taxation is through the allocation of taxing rights between the contracting States. When concluding a DTT, the two contracting States commit themselves to restrict their domestic taxing rights. This limitation in the domestic tax liability of the contracting States is done through the so-called allocation rules and the method article. While the allocation rules limit the taxing rights of the source State, the limitation in the residence State's right to tax is provided for in the method article (the exemption and credit method, see below).

In the OECD and the UN Models, the allocation rules are found in Articles 6 to 8 and Articles 10 to 21 for taxes on income and in Article 22 for taxes on capital. Each item of income or element of capital is attributable to only one allocation rule. Overlaps are mediated through priority rules in the DTT.

The allocation rules of a DTT distribute the taxing rights on the income and capital covered by the treaty between the "residence State" and the "source State". In some instances, one State is exclusively entitled to tax whereas in others, taxing rights exist concurrently. When the allocation rule allows a certain item of income or capital to be taxed in both contracting States, the residence State will have to apply the method article to ensure that double taxation is eliminated.

## A. Treatment of active business income

Article 7 of the OECD and UN MTCs deals with active business income, which is described as all income derived from the active conduct of a business of an enterprise, for example, income earned through the sale of goods or the provision of services. It is typically referred to as income earned from a business source other than investment income.

As a general rule, business profits, wherever arising, are exclusively taxable in the State of residence of the enterprise. An exception exists where an enterprise has a PE in the State where the income arises. The PE State may tax those profits that are attributable to the PE. If both, the source and residence State

tax the income attributable to a PE, the residence State is obliged under the DTT to eliminate any double taxation that may arise.

In this context, the PE concept, discussed above, is used in DTTs as a threshold rule for determining whether a State has taxing rights over the business profits of a non-resident taxpayer. It acts as a source rule by setting the level of nexus (or presence) that is required.

Once the PE threshold is met, it will be necessary to determine how much of these profits the source State may actually tax. For DTT purposes, the general rule is that the PE State is only entitled to tax the profits that are attributable to such a PE. The attribution of profits to a PE is generally based on the separate entity accounting and arm's length principles. Accordingly, the profits that are attributable to a PE are those that it could be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with other parts of the enterprise. As each legal entity or PE is treated separately, the conditions of intragroup transactions may be readjusted to reflect those that would prevail if these were carried out between independent enterprises (the arm's length principle).

While this approach is endorsed by both the OECD and the UN Models, some deviations between them exist. For example, the UN Model provides for the limited force of attraction principle (Article 7(1)(b) of the UN MTC), which has been implemented in a large number of DTTs. Under this principle, the PE State is allowed to tax not only the profits that are attributable to the PE, but also business profits from similar transactions generated by the enterprise in the PE State, even if conducted outside the PE. The idea behind this provision is to extend the taxing rights of the source State.

Although the PE definition adopted in DTTs is widely used for the purposes of allocating taxing rights for business profits, it may not be sufficient or no longer appropriate for the increasingly digitalized economy. This is because, as mentioned earlier, the PE concept still largely relies on physical presence in the source State as a trigger for taxation. Nowadays persons can carry on business or provide services abroad without the need for a physical presence. This is of particular concern for so-called market jurisdictions, the place where the value is created. If the physical presence threshold established under DTTs is not met, that State may not be entitled to tax the income, for example, from digital activities and services. As discussed below, post-BEPS reform to address this problem is currently underway.

## B. Treatment of passive income

Passive income, not derived from any active business, generally encompasses income from investments, such as dividends, interest and royalties. DTTs often allow for such income to be taxed by the source State by means of a withholding tax (WHT) on gross income. No PE is required to exist in the source State for such taxation.

DTTs impose certain limitations on the source State's taxing rights, by providing that it cannot exceed a certain tax rate on gross income. The residence State, in turn, is not precluded from also taxing the income but is required to alleviate any double taxation that arises.

As the taxpayer has no physical presence in the source State, the tax is collected by means of a WHT, a mechanism whereby the counterparty of the taxpayer, meaning the person who makes the payment, acts as a withholding agent and remits the WHT to its local tax authorities. This makes a WHT a simple, reliable and efficient method of enforcing the tax imposed on non-resident taxpayers.

The recipient of income from dividends, interest or royalties will benefit from the DTT limitations on WHT rates only if this person is the "beneficial owner" of the income. The requirement was introduced to address situations where recipients of the payment are legally, contractually or factually obliged to immediately pass it on to another person.

The application of a gross basis WHT may have some distorting effects in certain situations as it may represent an entry barrier or lead to taxation of loss-making entities. Despite these issues, the WHT mechanism is still a convenient and effective method for countries, especially developing countries, to collect and administer taxes levied on non-residents.

Different WHT rates are found in DTTs. The OECD MTC explicitly provides for source taxation rates in relation to different types of income. For dividends it limits the taxation at source to 15 per cent. If the beneficial owner is a company that directly holds at least 25 per cent of the capital of the company paying the dividends the limit is reduced to 5 per cent. For interest income, the WHT rate is 10 per cent under the OECD Model. With regard to royalties, the OECD MTC grants exclusive taxing rights to the residence State. The UN Model does not stipulate any rate for dividends, interest payments or royalties, leaving it open to both States to negotiate bilaterally. Many treaties deviate from the OECD MTC approach to royalties and follow the UN Model, agreeing bilaterally to a certain rate. The approach of the UN MTC is a consequence of its generally greater deference to tax rights for source States.

After the WHT is applied by the source State, the State of residence is also entitled to tax but required to alleviate any double taxation that arises.

## C. Treatment of individuals’ income

In addition to earning passive income, individuals may also receive other types of cross-border income that are specifically covered by the allocation rules of DTTs. The OECD and UN Models apply different rules to the allocation of taxing rights on individuals’ income depending on whether such income is derived from dependent or independent personal services – in general terms, corresponding to income from employment and self-employment.

Income from dependent personal services, or employment, is addressed in Article 15 of the OECD and the UN MTCs and treated similarly by both. The taxing rights on salaries, wages and other similar remuneration are exclusively allocated to the residence State of the recipient (the employee), unless this person exercises the employment in the other State. The rule, thus, relies on the State of activity, i.e. the place of work principle, with limited exceptions in Articles 15(2) and (3) of the OECD and UN MTCs.

Income from independent personal services is dealt with separately in the UN MTC under Article 14 and until 2000 also the OECD model. “Professional services” for the purposes of the UN MTC include especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

The allocation rule determines that income from professional services or other activities of an independent character shall be taxable only in the residence State of its recipient unless the individual has a fixed base available in the other State or if the individual stays in the other State for 183 days in any 12-month period. The income that the other State may tax is only so much as is attributable to that fixed base or derived from the individual’s activities performed in the other State. The residence State is not prevented from taxing this income. For DTTs following the current OECD approach, income derived from professional services or other activities of an independent character is now dealt with under the provision on business profits.

The current framework for source taxation of personal services, both dependent and independent, hinges heavily on the physical presence of individuals, which faces challenges in today’s digital world. While the issue of physical presence has been largely discussed in the field of corporate income taxes, especially under the BEPS Project, the physical presence of individuals as a key component in the allocation of taxing rights under DTTs may require increased attention in the future. Applying existing rules to this “new” reality could give rise to significant tax competition in attracting digital nomads and potentially eroding the tax base of countries. It is important for the investment community to be aware of the likely debate on the

nexus for taxing labour and inform the discussion with its perspectives on the matter, as changes in the tax framework could have profound consequences for certain types of investment.

**Table 11.** Pre-BEPS approach frequently used in DTTs

| Approach | General implication |
| --- | --- |
| Active business income: the allocation of taxing rights on the business profits of an enterprise favours taxation in the residence State of the enterprise. The only exception arises if the enterprise has a PE in the source State through which the business is conducted. | The allocation of taxing rights varies depending on the existence of a PE in the other (source) State. In principle, the enterprise's residence State has exclusive taxing rights on its profits. If, however, the enterprise carries on business in the other State through a PE situated therein, the PE State may also tax the profits attributable to that PE. Double taxation of the profits attributable to the PE will be avoided through the application of the method article. |
| Passive income: the allocation of taxing rights on passive income usually allows it to be taxed in both States (with some exceptions). | Passive income may be taxable in the source State even if no PE or fixed base is located therein. The source State will tax on a gross basis, by means of a WHT. However, its right to tax is normally limited to a certain tax rate. Whether in these cases the residence State also has the right to tax depends on the method through which double taxation is alleviated. |
| Individuals' income: DTTs assign taxing rights on personal income to the State of residence of the worker or self-employed individual. However, the rules also follow the place-of-work principle, whereby the State where the activity is performed may also be entitled to tax, subject to exceptions. | The allocation rule for income received from individuals' professional activities differs based on whether it is income from dependent (employment) or independent (self-employment) services.<br><br>Income from dependent personal services is allocated exclusively to the residence State of the recipient, unless the activity is exercised in the other State. The taxation of income from independent personal services is also exclusively allocated to the residence State of the recipient, unless this person performs the activities in the other State through a fixed base regularly available to this person or stays in the other State for more than 183 days. |

*Source:* UNCTAD.

## Takeaway for investment policymakers: reform options for the allocation rules

Digitalization is greatly transforming the organization and functioning of the global economy. The physical presence of a business or an individual to carry on activities or provide services in the market jurisdiction is becoming less relevant. DTTs, however, have long relied on physical presence as a nexus criterion for source State taxation. Consequently, the rules on business profits, for example, make it possible for an online business to extensively trade with or do business in a State without triggering compliance obligations for corporate income tax purposes. Similarly, an individual must be physically present in the source State when exercising its dependent or independent work for the purposes of source taxation. These rules were developed before the spread of mobile or remote working and can lead to a misalignment between the State to which taxing rights are attributed and the State where the income is actually generated. Put differently, current DTT rules pose challenges to the allocation of taxing rights to market jurisdictions.

In response, structural reforms are being undertaken at the OECD and the UN to bring taxing rights in line with the new digital reality by creating new nexus rules that are not exclusively based on physical presence.

Proposals are being put forward to adopt alternatives to the PE threshold in DTTs as a trigger for source taxation, including under Pillar One of BEPS 2.0.[3] Pillar One might lead to a conceptual expansion of the nexus traditionally enshrined in the PE concept. The idea is to allow the allocation of taxing rights to the State where the economic activities take place and the value is created. This would imply allocating taxing rights to user and market jurisdictions or locations where business activities are conducted without a physical presence.

The UN MTC has equally introduced two novel provisions on technical services and automated digital services in 2017 and 2021 respectively.

Some countries have traditionally considered that services (in particular, technical services) should be taxed in the State of the recipient of the service even without the physical presence (PE or fixed base) of the provider in that State. However, previously no specific allocation rules existed, requiring countries to find a workaround by adopting the policy of including fees for (technical) services in the definition of royalties. Now, a specific template for countries wanting to tax fees for technical services at source is included in Article 12A of the UN MTC.

For the purposes of the Model, fees for technical services include any payment for managerial, technical or consultancy services, unless the payment is made (i) to an employee of the person making the payment, (ii) for teaching in or by an educational institution or (iii) by an individual for services for personal use by an individual. Its allocation rule is similar to that applicable to royalties, discussed above. Fees for technical services may be taxed in the source State, on a gross basis WHT; however, source taxation is limited to a certain rate, which is left open in the UN MTC for States to bilaterally negotiate. Also, the residence State is still entitled to tax these fees but will have to alleviate double taxation that may arise.

In its 2021 version, the UN Model included another new provision to specifically deal with income from automated digital services (ADS) (Article 12B of the UN MTC). The significant growth in the number of businesses providing digitalized and automated services raised doubts as to whether existing DTT provisions would be suitable. Since the PE threshold is highly dependent on a physical presence in the source State, concerns have emerged over the potential lack of taxation of ADS in the country where "value creation" occurs (referred to as source or market jurisdiction), which have raised a strong sense of unfairness. To address these concerns, the UN MTC added a new allocation rule on ADS. For the purposes of the provision, ADS are services provided on the Internet or other electronic network requiring minimal human involvement from the service provider. Under Article 12B of the UN Model, the term ADS includes especially (a) online advertising services, (b) supply of user data, (c) online search engines, (d) online intermediation platform services, (e) social media platforms, (f) digital content services, (g) online gaming, (h) cloud computing services and (i) standardized online teaching services.

Similarly to other provisions, the allocation rule for income from ADS allows the source State (i.e. the State where the payer of the fees for the service is located) to impose a gross basis WHT. Source taxation is limited to a bilaterally negotiated rate. As with fees for technical services, the residence State of the recipient is also entitled to tax and will have to grant relief for any potential double taxation. The nexus established under the ADS provision is the location of the payer of the ADS fee. It does not require the recipient of the payment to have a source State PE, fixed base or spend a minimum period of time in the source State.

While this solution has been assessed as a simpler and better suited proposal for the needs of developing countries than that of Pillar One, several concerns about its adoption have been put forward.[4] Nevertheless,

[3] For an overview, see, the Website of the OECD, Action 1 - Tax Challenges Arising from Digitalisation, https://www.oecd.org/tax/beps/beps-actions/action1/.

[4] As set out in paras 8-16, of the Commentary on Article 12B of the UN MTC. See also, for example, Baez Moreno (2021). *Because Not Always B Comes after A: Critical Reflections on the New Article 12B of the UN Model on Automated Digital Services*, 13 World Tax J. 4; Andrade Rodríguez (2021). *Developing Countries and the Proposed Article 12B of the UN Model: Some Known Unknowns*, 4 Intl. Tax Stud. 6; and Chand and Villaseca, *The UN proposal on automated digital services: Is it in the interest of developing countries?* sec. 4(a), Kluwer International Tax Blog (5 March 2021).

as it is a newly proposed provision, its implementation in DTTs may still take some time and allow for certain amendments as deemed necessary.

It is important for investment policymakers to be aware of these international tax reforms aimed at reallocating taxing rights in a digitalized economy, as they may have an impact on the location of investment and the strategies used to attract FDI flows. These reforms may cause a change in the way firms and individuals trade goods and services or do business in a country, which can have an effect on how investments are strategized and placed worldwide.

### Table 12. Post-BEPS approach frequently used in DTTs

| Reform options | General implication |
|---|---|
| Active business income:<br>Implement changes in the nexus for source taxation, by (i) broadening the PE concept in DTTs and (ii) providing alternative thresholds to the PE requirement, taking into consideration where the economic activities take place and value is created. | By reforming and broadening the PE concept and the nexus for source taxation in DTTs, States will expand not only the tax revenues collected at the source, but also the compliance burden for foreign investors. This may have implications for investment decisions as investors would ponder how additional compliance costs and tax payments affect their business. Moreover, contracting States need to ensure a consistent interpretation of the relevant provisions, so that their application does not result in double taxation. |
| Passive income:<br>Improve anti-abuse rules to avoid granting the reduced WHT rates of DTTs in abusive situations (discussed below). | The reliance on gross basis WHT in relation to passive income stems from the fact that this mechanism is considered a simple, reliable and efficient method to enforce taxes imposed on foreign income, being especially useful for the potentially limited administrative resources of developing countries.<br>Investors have a strong incentive to engage in treaty-shopping structures in pursuit of the most beneficial rate. Policymakers may want to consider adopting DTT anti-abuse provisions on the determination of beneficial ownership and/or a general anti-avoidance rule, discussed below. |
| Individuals' income:<br>Clarify and amend the application of the allocation rules on income from dependent and independent personal services to align them with the new remote working reality. | The BEPS Project has raised the issue of the heavy reliance in DTTs on physical presence with respect to corporate income tax. Similar issues exist in respect of the taxation of remote workers providing dependent and independent personal services.<br>Investment policymakers need to be aware of potential tax reforms to address international mobile work situations and reduce or remove the reliance on physical presence for the allocation of taxing rights between States. Reforms may have an impact on the strategies adopted by firms and individuals with respect to the location of investments. |

*Source:* UNCTAD.

# 6. METHODS FOR ELIMINATION OF DOUBLE TAXATION

DTTs provide for two alternative methods for the residence State to eliminate double taxation, the exemption method and the credit method.

## What investment policymakers need to know about the pre-BEPS approach to methods for the elimination of double taxation

The method article is the provision of DTTs that eliminates double taxation that can arise where the allocation rules allow concurrent taxation by the source and residence States. When concluding a DTT, the contracting States can choose from two methods: (i) the exemption method, under which the residence State will not tax certain income derived in the source State, by excluding it from the resident's domestic tax base; and (ii) the credit method, under which the residence State may tax the foreign-sourced income but will grant a credit for the taxes already paid in the source State. The different methods have different impacts on tax incentives adopted in source States to attract foreign investment. The ongoing BEPS process is likely to profoundly affect such incentives through the adoption of the global minimum tax and subject-to-tax clauses in DTTs.

If, as a result of the application of the relevant allocation rule of a DTT, taxing rights exist for both contracting States, double taxation has to be eliminated by applying the method article. The method article addresses the residence State, which is obliged to grant relief for the double taxation of income or capital covered by the DTT. In cases where the allocation rule assigns exclusive taxing rights to only one State, the application of the method article is not necessary.

During negotiations of a DTT, contracting States can choose between two alternative methods for the relief of double taxation: the exemption method and the credit method. Both the OECD and the UN Models feature two provisions: Article 23A dealing with the exemption method, and Article 23B featuring the credit method. Contracting States are free to adopt different methods in a single DTT or to use a combination of the two.

For DTT purposes, the method article deals only with so-called juridical double taxation, i.e. where the same income or capital in the hands of the same person is taxable by the two contracting States. It does not, in principle, deal with economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. For example, under DTTs, dividends paid by a company to a foreign shareholder may be taxable in both States. In this situation, juridical double taxation arises because the dividends are taxable in the hands of the same person, the shareholder, in the State of the distributing company (by means of a WHT) and in the State of the foreign shareholder upon receipt. Economic double taxation also arises because the company in the source State pays corporate income tax on its profits. These (already taxed) profits are subsequently distributed as dividends and taxed again. In the second case, the same income is taxed at different times in the hands of different persons. DTTs only deal with the first type of double taxation.

The decision to apply one method to eliminate double taxation over the other is underpinned by specific investment considerations and policy goals that States pursue. A question of interest for investment policymakers with regard to the methods for the elimination of double taxation in DTTs may be what a State intends to achieve in terms of neutrality, competitiveness, simplicity and economic efficiency with the tax system.

States choosing the exemption method generally aim at achieving capital import neutrality, focusing on guaranteeing equally competitive conditions in the source State. As such, all investors investing in a State are subject to the same tax treatment: the one applicable in the State of the source of the investment income. States choosing the credit method instead aim to achieve capital export neutrality by ensuring equal treatment in the residence State, regardless of where a capital investment is made.

## A. Exemption method

The exemption avoids double taxation by disregarding the foreign earned income for purposes of calculating the tax base in the residence State. This method, thus, does not affect the applicable tax rate but the amount of income included in the taxable base.

Sometimes specific clauses are included in the method article of DTTs to avoid double non-taxation that can arise from the application of the exemption method. First, "subject-to-tax clauses" are often found in DTTs, where the exemption in the residence State will depend on whether taxes are levied in the source State. That is, the residence State will be obliged to grant an exemption for the relevant income according to the method article in the DTT only if the source State actually levies a tax on such income. Otherwise, the residence State is allowed to tax such income according to its domestic law and is not limited by the DTT. The subject-to-tax clause can be adopted either only in relation to specific rules that concern income more prone to double non-taxation or in general, as a condition for applying the exemption method. The OECD and UN MTCs do not contain such clauses.[5]

Moreover, "switch-over clauses" are also often included in DTTs to allow the residence State to change from the exemption to the credit method in certain circumstances. These clauses are usually applicable where the use of the exemption would result in double non-taxation, and in cases of abuse. The OECD and the UN Models include a provision in Article 23A(4) that generally has a similar effect to these clauses. It grants the residence State the right to switch from the exemption to the credit method whenever different interpretations of the DTT (also known as conflict of qualification) would result in double non-taxation or low-taxation because of the application of the allocation rules on dividends, interest, royalties (in the UN Model), fees for technical services and income from ADS.

## B. Credit method

The credit method has no effect on the taxable base in the residence State; it affects only the amount of tax levied by that State. That is, when the credit method applies, the residence State will first determine the tax due on the worldwide income of its resident taxpayer under domestic law. It then reduces this tax by the foreign tax paid at the source. As such, the credit method allows taxation in both contracting States and double taxation is avoided only in relation to the amount of tax levied at source. The credit method guarantees that cross-border income will be taxed at least in one of the contracting States. States usually choose the credit method for passive income.

If the tax rate in the residence State is higher than that applied in the source State, the taxpayer will pay the difference until the higher rate in the residence State is achieved. However, Article 23B(1) of the OECD and UN MTCs stipulates that if the tax rate in the source State is higher than in the residence State, the latter is obliged to grant a credit only for the maximum amount of tax that would be levied in the residence State (before the credit). This means that the residence State is limited to a "maximum tax credit", whereby it will not credit any more tax from the source State than it would levy under its domestic law.

The amount of tax that will be offset in the residence State is, in principle, the amount legally due and effectively levied in the source State. However, some DTTs provide for exceptions to this rule by including

[5] See para. 2, Commentary on Article 23 of the OECD MTC 2017 and para. 2, Commentary on Article 23 of the UN MTC.

“tax sparing provisions”. These provisions are intended to stimulate or attract capital investment in the source State and are particularly present in DTTs concluded with developing countries. They ensure that if the source State grants a tax incentive to foreign investors, the incentive will not be offset by higher taxes in the residence State. The tax-sparing mechanism is a means to correct the distortions introduced by the credit method on the source State’s right to design its tax policy and decide not to tax (or to tax at a lower level) the income attributed to it under the DTT for policy or regulatory reasons.

Over the years, the use of tax sparing has raised divergent opinions in the international tax community. Since 1998, the OECD has not supported their use, recommending instead that countries adopt tax-sparing clauses only in DTTs with countries that have a considerably lower level of economic development than the OECD member countries (OECD 1998b).6 The UN Model adopts a neutral position on tax sparing clauses, neither supporting nor explicitly rejecting their adoption in DTTs.7 However, it recognizes the importance of ensuring that tax incentive measures in developing countries are not made ineffective by taxation in capital-exporting countries that use a foreign tax credit system.

**Table 13.** Pre-BEPS approach frequently used in DTTs

| Approach | General implication |
|---|---|
| DTTs eliminate the remaining double taxation of covered income or capital after application of the relevant allocation rules through two alternative methods: the exemption method and the credit method. | The exemption method affects the taxable base, as the residence State will exclude the foreign income from the computation of the resident’s worldwide income. As such, the decision whether or not to tax income assigned to it under the DTT relies on the source State.<br><br>The credit method allows taxation in both contracting States. Double taxation is avoided by the residence State, which credits the amount of tax paid in the source State against the tax levied therein. Under this method, the source State’s decision whether or not to tax income assigned to it under the DTT is neutralized, as residual taxes are imposed by the residence State. |

*Source:* UNCTAD.

## Takeaway for investment policymakers: reform options for the methods for elimination of double taxation

The effectiveness of the use of tax incentives and tax-sparing provisions to attract investment has been highly debated. With respect to corporate income taxes, the future of tax incentives and tax-sparing provisions seems uncertain in light of the recent international tax reform under BEPS 2.0. The OECD Pillar Two introduces a global minimum level of corporate tax of 15 per cent applicable to large MNEs wherever they operate (OECD, 2021). As such, tax incentives that reduce the effective tax rate on corporate profits below 15 per cent are expected to be significantly affected (UNCTAD, 2022; OECD, 2022). This will also render tax-sparing provisions in DTTs ineffective if their application leads to an effective tax rate below 15 per cent.

Moreover, DTTs do not prevent instances of double non-taxation whenever taxing rights are attributed exclusively to a jurisdiction that fails to exercise them under its domestic law. The introduction of subject-to-tax clauses could prevent such double non-taxation by limiting States’ right to tax under a DTT only

[6] The conclusions of the Report were introduced into the OECD Model (Commentary on Article 23B, paras. 72-78) and remain unchanged in the MTC’s latest version from 2017.

[7] See Commentary on Article 23 of the UN MTC, paras 3-12.

where the State possessing the exclusive taxing rights actually levies tax on the relevant item of income. If no taxation is exercised by this State, the other State, which was in principle precluded from taxing, would be entitled to tax such income. As DTTs generally limit source taxation, these provisions are of particular importance for developing States, which are often in the source position in the bilateral situations covered by DTTs. In this context, as discussed above, the UN Tax Committee recently approved the introduction of a general subject-to-tax clause in the next version of the UN Model (Committee of Experts on International Cooperation in Tax Matters 2023). Under this new clause, the source State will be entitled to tax any income for which it has given up the taxing rights if the residence State has not taxed this income up to a certain bilaterally negotiated minimum rate. The OECD has released its own version of a subject-to-tax rule under Pillar Two (OECD 2023b).

These recent developments, the global minimum tax and the inclusion of subject-to-tax rules, may have a profound impact on investment policies. This is especially true in relation to the ability of States to offer tax incentives to attract FDI (UNCTAD, 2022). Existing tax competition for investment will decrease, turning these tax reforms into an opportunity to review investment promotion measures and costly incentives. Governments will need to rethink their policies and strategies aimed at encouraging investment into their territories and ensure that they do not rely on tax incentives that are significantly affected by these measures. Structural reform may be needed to align tax and investment policies with these recent developments.

### Table 14. Post-BEPS approach frequently used in DTTs

| Reform options | General implication |
| --- | --- |
| Adopt subject-to-tax clauses to ensure that taxation is exercised in at least one contracting State. | The introduction of subject-to-tax clauses could prevent double non-taxation as a consequence of the application of a DTT. They can do so from the point of view of the source and the residence State.<br>First, subject-to-tax provisions could prevent double non-taxation whenever taxing rights are exclusively attributed to a jurisdiction and that jurisdiction fails to exercise them. Limitations on the other State's ability to tax would occur only provided that the State possessing the exclusive taxing rights actually taxes the item of income. This could also prevent double non-taxation if the exemption method is applicable, where exemption in the residence State will depend on whether taxes are levied in the source State.<br>Given recent developments in the international tax arena, opportunities for double non-taxation are more limited. When States allow non-taxation in their territory, this will often merely shift taxation to another State. |
| Review tax-sparing provisions in line with recent developments in international taxation. | Tax-sparing provisions in DTTs can also be reviewed as their effectiveness in terms of investment attraction, especially after the introduction of Pillar Two, may change significantly. Investment policymakers should assess the benefits and costs that tax incentives and tax-sparing provisions bring for investment and rethink their strategies to align them with the changing international tax landscape. |

*Source:* UNCTAD.

# 7. ANTI-ABUSE PROVISIONS

Anti-abuse provisions restrict the entitlement to DTT benefits in situations where non-taxation or reduced taxation is achieved, in particular through treaty-shopping arrangements.

## What investment policymakers need to know about anti-abuse provisions in DTTs

Anti-abuse provisions in DTTs were developed to specifically prevent treaty shopping and tax avoidance arising from the improper use of a DTT. Contracting States may choose between three methods: (i) a principal purpose test (PPT) provision, (ii) a combination of a PPT provision and a limitation of benefits (LoB) rule or (iii) an LoB provision together with a rule against conduit arrangements. The PPT combines subjective and objective elements, and its implementation requires a lower level of administrative capacity. The LoB provision is fully objective. It creates greater certainty for taxpayers but is highly complex and may exceed the capacities of developing economies. The anti-abuse rules were developed as a result of the BEPS Project and are treated as minimum standards, requiring adoption by countries participating in the BEPS Inclusive Framework.

When a State enters into a DTT, it effectively concludes the treaty not only with its counterpart jurisdiction but also with the rest of the world. This is because private parties can structure their operations with a view to benefitting from the most favourable DTTs. Persons who are not directly entitled to the benefits of a DTT, for example, because they are residents of a third State, can indirectly obtain DTT benefits such as reduced WHT on passive income through treaty shopping. This frustrates the reciprocal nature of DTTs. By seeking to limit access to treaty benefits in a DTT itself, States preserve the premise that DTTs promote cross-border trade and investment on a bilateral basis, and that the benefits of DTTs come at a fiscal cost to the State and should be limited only to the intended bilateral relationship (quid pro quo). In a sense, the treaty-shopping issue is similar to the one under international investment agreements (UNCTAD, 2021).8

Until the BEPS Project, the OECD and UN Models (and the majority of DTTs) did not include any substantive provision that comprehensively dealt with the improper use of DTTs. Previously, treaties already contained some specific anti-avoidance rules, such as the “beneficial owner” test, which was introduced into the dividends, interest and royalties articles. Moreover, the commentaries to the OECD and UN MTCs state that DTTs also aim to prevent tax avoidance and tax evasion. Both commentaries further included suggestions on the use of domestic anti-abuse provisions to deny DTT benefits in improper circumstances.[9]

However, this approach has proved insufficient. In response, BEPS Action 6 developed specific DTT provisions to prevent treaty shopping and DTT abuse. Agreed as a minimum standard, Action 6 requires States that participate in the OECD Inclusive Framework on BEPS to include two components in their DTTs. First, the preamble of the DTT should clearly provide that the contracting States intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, discussed above. Second, Action 6 introduced new provisions to prevent the granting of treaty benefits in inappropriate circumstances: a principal purpose test (PPT) and a limitation of benefits (LoB) provision that can now be found in Article 29 of the OECD and UN MTCs.

Broadly, States can choose between three methods of addressing treaty shopping: (i) the PPT alone, (ii) a combination of the PPT rule and (a simplified or detailed version of) the LoB provision, or (iii) a detailed version of the LoB provision together with a rule against conduit arrangements. Many DTTs have been amended to implement the recommendations of Action 6.

8 The approach to tackling treaty shopping is, however, different.

9 OECD MTC 2017, Commentary on Article 1, paras. 66-80; UN MTC 2021, Commentary on Article 1, paras. 56-72.

In addition to these new treaty rules, domestic legislation continues to be highly relevant. The enforcement and administration of anti-abuse rules in DTTs may be facilitated if the State already has a domestic framework in place that is in line with such rules, which can even reduce the costs of their implementation. States may also choose to rely exclusively on their domestic anti-abuse legislation, which would provide them with great flexibility in their application. However, the domestic approach may result in divergent applications of the same DTT in the two contracting States, leading to uncertainty for investors.

The choice of applicable rule can have a significant impact on investment decisions, as the rules' weaknesses may act as barriers to investors wishing to enter a country. It is important for policymakers to provide legal certainty and assurances that DTT benefits will be granted to investors as long as there is no abuse. Although it may be difficult to comprehensively define which transactions and actions could constitute abuse, providing the possibility for taxpayers to rebut the test and prove that a transaction is legitimate may be an important way to establish a relationship of mutual trust.

## A. Principal purpose test

The PPT rule provides that DTT benefits shall not be granted if one of the principal purposes of any arrangement or transaction was to obtain such benefits, unless granting the benefits would be in accordance with the object and purpose of the relevant provisions of the DTT.

Accordingly, the PPT includes both a subjective and an objective element. Under the subjective test, DTT benefits will be denied for a certain arrangement or transaction if it is reasonable to conclude that one of the principal purposes of such arrangement or transaction is to obtain a tax benefit. This provides tax authorities with a great deal of discretion in applying DTTs as obtaining a DTT benefit only needs to be one of the principal purposes of the arrangement (rather than the main purpose). Under the objective test, if the arrangement or transaction is in line with the object and purpose of the DTT, there will be no abuse and the benefits will not be denied. This give the taxpayer the opportunity to prove that there are other genuine business purposes that are greater than the tax benefits, which are aligned with the object and purpose of the treaty.

The PPT is a simple rule and is relatively easy to apply, especially for developing countries with limited administrative capacity. Moreover, its objective element allows the consideration of the genuine nature of the structure, bringing flexibility. Nevertheless, its subjective element entails a degree of legal uncertainty and unpredictability. The text of the PPT is vague, and the terms used are not clearly defined, which may result in differing interpretations of the provision by tax authorities and domestic courts. While the taxpayer will be allowed to prove that there were other business purposes under the PPT, it still gives tax authorities broad discretion in deciding on access to DTT benefits.

## B. Limitation of benefits clause

The LoB provisions seeks to deny benefits of a DTT to taxpayers who, even though they satisfy the personal scope of the DTT, are not "qualified persons". Two versions exist: a simplified LoB provision and a detailed one. However, being a specific anti-avoidance rule that only prevents the circumvention of the personal scope of the treaty (residency), the provision has to be supplemented to tackle other types of abuse.

It provides a more objective approach when establishing the qualification for DTT benefits. This is because the LoB is assessed through a series of alternative tests based on clearly defined factors, such as benefits covered, the qualified persons test, and the active business test. It is a more complex rule derived from United States DTT practice and has a very strict effect as it is a fully objective test. As such, the LoB provides for more predictable outcomes and leads to greater legal certainty for the granting of DTT benefits. However, the LoB tests do not provide for flexibility and if their specific conditions are not met,

the rule leads to the denial of DTT benefits even if there is no treaty-shopping purpose, i.e. if the business structure in question was adopted for genuine commercial purposes. It also covers only treaty-shopping structures and therefore should be supplemented by either a PPT or an anti-conduit mechanism to tackle other types of treaty abuse.

In both its simplified and its detailed versions, the LoB clause's technical and mechanical structure requires a high level of expertise. Because of its complexity as well as constant expansions and refinements of the provision to try to capture all possible avoidance structures, it requires a tax administration capable of applying its tests and may lead to higher implementation costs. All these factors may act as barriers to its adoption by developing countries that have limited administrative capacity. In case of limited capacities, a more general anti-abuse provision may be more apt.

### Table 15. Post-BEPS approach frequently used in DTTs

| Approach | General implication |
|---|---|
| Adopt an anti-abuse provision in DTTs, in addition to domestic anti-avoidance provisions. | In choosing between the rules applicable in DTTs, investment policymakers will have to weigh the advantages and disadvantages of the different anti-abuse provisions. |
| The principal purpose test (PPT) denies DTT benefits if one of the main purposes of the transaction or arrangement is to obtain the tax benefit. However, the taxpayer can prove that the transaction has other genuine purposes. | The PPT is a general anti-abuse rule, which is relatively easy to enforce and administer. It also ensures flexibility in its application as the taxpayer can prove that the transaction has genuine business purposes. The PPT might be the preferable option for countries with limited administrative capacity. However, it gives tax authorities a great deal of discretion, which brings uncertainty to taxpayers. |
| A limitation of benefits clause (LoB) denies DTT benefits based on an objective approach that is assessed through a series of alternative tests. | The LoB clause is a more complex rule. However, it brings predictability and legal certainty to taxpayers as it is fully based on objective tests. However, genuine arrangements could falsely be considered to be abusive if no flexibility is provided. Moreover, it is limited to treaty-shopping structures and needs to be complemented by other provisions to have a broader scope of application. Its application requires a high level of expertise on the part of tax authorities and can entail high implementation costs, which may prevent countries with limited administrative capacity from adopting it. |

*Source:* UNCTAD.

# 8. NON-DISCRIMINATION

The non-discrimination provision aims to protect foreign investment from discriminatory tax treatment.

## What investment policymakers need to know about non-discrimination in DTTs

The non-discrimination provision in DTTs prohibits tax discrimination in a number of listed circumstances. Its main objective is to prevent differences in tax treatment that are based on specific grounds such as different nationalities or PE status as opposed to being an enterprise of the State in question. The provision differs from seemingly similar clauses in IIAs and preferential trade agreements by allowing de facto discriminatory treatment and explicitly allowing differences in treatment between residents and non-residents.

DTTs commonly include a non-discrimination provision. The provision aims to eliminate tax discrimination in a number of listed circumstances such as disparate treatment of nationals of different States, less favourable treatment for PEs than that granted to enterprises carrying out the same activities in a State as well as a number of other circumstances relating to interest, royalties, and debts. It is important to bear in mind that all tax systems incorporate legitimate distinctions based on differences in liability, ability to pay or residence. The non-discrimination provision tries to balance the need to prevent unjustified discrimination with the need to account for these legitimate distinctions. Importantly, the provision does not extend to de facto discrimination. For instance, discrimination based on nationality is prohibited. Distinctions based on residence in a State, in practice closely associated with nationality, are nevertheless permitted for tax purposes.

In addition, the provision does not provide for most-favoured-nation treatment. Tax conventions are based on the principle of reciprocity, and the beneficial tax treatment offered in DTTs is generally not extended to residents of third States. The main objective of the non-discrimination rules is to prevent differences in tax treatment that are based on specific grounds such as different nationalities or PE status as opposed to being an enterprise of that State. It is not intended to provide foreign nationals, non-residents, enterprises of other jurisdictions or domestic enterprises with foreign ownership or control with better tax treatment than that of nationals, residents or domestically owned or controlled businesses.

Investment policymakers should take note of the key differences between non-discrimination provisions in DTTs compared to those contained, in other treaties dealing with the economic relations between States such as international investment and preferential trade agreements. A key difference is the explicit acceptance of differences in treatment between resident and non-resident taxpayers in DTTs.

**Table 16.** Approach frequently used in DTTs

| Approach | General implication |
|---|---|
| Protect residents of one contracting State from more burden-some treatment than similarly situated residents of the other contracting State. | The provision aims to eliminate unjustified tax discrimination in certain precise circumstances. |

*Source:* UNCTAD.

# 9. DISPUTE RESOLUTION

DTTs contain their own mechanism for resolving disputes arising from the interpretation and application of treaty provisions.

## What investment policymakers need to know about the pre-BEPS approach to dispute resolution

To resolve disputes regarding the interpretation and application of DTTs, treaties provide for the MAP, a diplomatic means of settling tax disputes between the two tax authorities without any involvement of third parties. In some DTTs, if a dispute remains unresolved, binding arbitration complements the MAP as a second step. Taxpayers may, alternatively, opt to pursue the matter through the domestic courts of the contracting State where the dispute arose.

It is important that DTTs not only provide a set of substantive rights to taxpayers (and cross-border investors) but also that these rights are adequately enforceable in case of a breach. This strongly relates to the key objective of DTTs, to promote investment by removing double taxation.

Where an individual or enterprise considers that the actions of one or both contracting States result in taxation that is not in accordance with the DTT, that person or business may present the case to the concerned competent authority regardless of any remedies available under domestic law. A taxpayer may trigger the MAP by making a request. However, the procedure is then conducted between the competent authorities, and the taxpayer does not directly participate. The competent authorities endeavour to resolve the case by mutual agreement and directly communicate with one another to do so. Yet, the authorities are not obliged to reach an agreement. Instead, they are expected to make a best effort to find a resolution.

The degree to which the competent authorities can engage in this best effort depends not only on their willingness but also their administrative capacity to effectively take part in the process. The lack of administrative capacity can be an important hurdle in developing countries and especially in least developed countries. As a consequence, the MAP may not necessarily lead to a solution and the taxpayer may not always have further recourse. A strong and independent judiciary that provides for a remedy in case of breaches of a DTT has an important complementary role to play in this respect. Strengthening the dispute resolution mechanism under DTTs, including through capacity-building, is a question not only for tax policymaking but also investment policymaking.

**Table 17.** Pre-BEPS approach frequently used in DTTs

| Approach | General implication |
| --- | --- |
| DTTs provide for the MAP as the default dispute resolution mechanism, which requires that the competent authorities of the contracting States undertake a best effort to resolve the dispute. A small number of DTTs also includes binding arbitration. | DTTs rely predominantly on the MAP for dispute resolution. The procedure does not include the taxpayer and requires sufficient administrative capacity on the part of the competent authorities. The outcome of the procedure is uncertain, even if the competent authorities are genuinely engaged, as the two States may have different interpretations of the same DTT provision or principles. The MAP is led by tax authorities, which tend to weigh revenue implications rather than the investment importance of an adequate and effective MAP process.<br><br>Where failed MAP proceedings are not the consequence of a lack of capacity, the MAP might become more effective when coupled with clear deadlines and the threat of arbitration (see below). |

*Source:* UNCTAD.

## Takeaways for investment policymakers: Post-BEPS reform options for DTTs

Although already in existence before the BEPS Project, tax treaty arbitration between competent authorities received a significant boost since the conclusion of the work on BEPS Action 14.

In cases in which the MAP does not resolve the issue within a certain period of time, usually two or three years, a small, albeit growing, number of DTTs provide for binding arbitration between the competent authorities. Unlike ISDS under IIAs, the dispute resolution procedure under DTTs is solely between the contracting States and the taxpayer has no standing beyond initiating the procedure. Moreover, the procedure is much less formalized, and the authorities maintain control over the process until its very end. For example, even after concluding the arbitration, the competent authorities may mutually agree on an alternative solution. Moreover, the existence of the arbitration procedure does not necessarily imply its extensive use. Subsequent arbitration may make the MAP more effective simply by virtue of incentivizing the competent authorities to reach an agreement. However, if failure to reach agreement during the MAP is the consequence of a lack of capacity to effectively engage, binding arbitration is unable to solve the problem.

Investment policymakers should be aware of both the importance of effective DTT dispute resolution and the challenges it entails. Effective dispute resolution under DTTs can be a cornerstone of an environment that promotes investment. Improving DTT dispute settlement, especially in developing countries, is, however, not necessarily an easy task. The inability to effectively participate in dispute resolution can often be the consequence of limited financial and human resources as well as a lack of experience with accurately understanding the process and its goals. Moreover, DTT arbitration is often conflated with ISDS under IIAs. Given the significant differences between the two procedures, comparisons between tax arbitration and investor–State arbitration should be made with caution. In any case, adequate capacity of tax authorities to participate is an absolute precondition for any meaningful dispute resolution. Hence, capacity-building is a priority for improving the investment climate.

## Table 18. Post-BEPS approach frequently used in DTTs

| Reform options | General implication |
|---|---|
| Maintain a MAP exclusively, without an arbitration procedure, and improve its functioning by increasing the capacity of the competent authority. | This option leaves the greatest flexibility to tax authorities. Regardless of the existence of tax arbitration, a dysfunctional MAP might have a negative impact on investment because it could increase the risk of double taxation and the uncertainty related to potential disputes, as well as generally causing reputational damage to the country as a place to invest and do business. The building of adequate capacity to improve the functioning of the MAP is, hence, of paramount importance. |
| Improve the functioning of the MAP, together with binding arbitration, which considers the specific characteristics of the countries involved, including with respect to the pool of arbitrators that can be involved in the procedure. | Many countries remain apprehensive about arbitration in the tax context, and the existence of tax-related ISDS has further contributed to this apprehension. The experience of investment policymakers may help to inform the design of a tax arbitration process that responds to the problems identified in ISDS – in particular, by developing and implementing a more inclusive and acceptable dispute settlement framework. Experience with ISDS, knowing the main features of DTT arbitration and understanding the differences provides investment policymakers with the necessary tools to engage in this debate. |
| Introduce alternative dispute avoidance and resolution mechanisms | According to the United Nations Handbook on the Avoidance and Resolution of Tax Disputes, the provision of technical assistance to developing countries can improve their capacity to minimize and resolve tax disputes. Countries that remain averse to arbitration may also consider some forms of non-binding dispute resolution such as mediation or expert evaluation. |

*Source:* UNCTAD.

# 10. EXCHANGE OF INFORMATION

International rules on EOI allow tax authorities to share relevant information, which enables the effective enforcement of tax laws.

## What investment policymakers need to know about the pre-BEPS approach to EOI

The provision on EOI requires that competent authorities (typically tax authorities of each contracting State) exchange information where it is relevant to applying the provisions of the DTT or to administering or enforcing the domestic tax laws of either State. Different types of EOI exist, on request, spontaneous and automatic, with the latter constituting the post-BEPS best practice. Capacity constraints continue to pose challenges to effective EOI, particularly in developing countries.

Through EOI, now contained in Article 26 of the OECD and UN MTCs, competent authorities of both contracting States may exchange information concerning a taxpayer or their affairs. Any information received is treated as confidential and can only be disclosed to authorities tasked with the assessment or collection of taxes. The information may be used only to assess, collect, enforce, prosecute or determine appeals (including in public court proceedings). The EOI provision is not constrained by the scope of the DTT, meaning information about non-residents and taxes not covered by the treaty may be exchanged.

The EOI provision does not entitle or place an obligation on either contracting State to carry out measures that are not in compliance with their laws and administrative practices, to supply information not obtainable under domestic law, or to supply information disclosing any trade, business, industrial or commercial secret. Moreover, competent authorities should not disclose information where this would be contrary to public policy.

Provisions concerning cooperation between the tax administrations of the parties to the DTT are essential. They support authorities in seeking to ascertain the facts to which DTT rules or domestic tax laws are applied. Due to the internationalization of economic relations, the reciprocal exchange of information to permit the administration of tax laws is generally necessary even if it does not relate to the application of the DTT. Aside from DTTs, one of the key multilateral frameworks available to countries to facilitate cooperation, particularly EOI, is the Convention on Mutual Administrative Assistance in Tax Matters (MAATM) (OECD 2023c). The MAATM was developed in 1988 to facilitate cooperation between tax administrations to tackle tax evasion and avoidance. Types of cooperation covered by the instrument range from EOI to the recovery of foreign tax claims. Currently, 147 jurisdictions participate in the MAATM.

In 1998 the OECD's work on harmful tax practices already identified that a lack of effective exchange of information poses a problem. As a result of this initial work, the OECD launched its work on this issue, which is currently undertaken by the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Global Forum has a membership of more than 160 jurisdictions. It monitors the implementation of standards on EOI through peer reviews, capacity-building and technical assistance programmes. Three key methods for EOI exist:

- Exchange of Information on Request – one competent authority requests particular information from another competent authority
- Spontaneous Exchange of Information – foreseeably relevant information that has not been previously requested is provided to another contracting party
- Automatic Exchange of Information – the systematic and periodic transmission of bulk taxpayer information concerning various categories of income.

Overall, transparency with respect to all jurisdictions where a taxpayer operates is important to counter tax evasion and avoidance. Investment policymakers should be aware of the importance that fellow contracting parties to preferential trade, investment and tax agreements comply with international transparency standards and engage in EOI.

**Table 19.** Pre-BEPS approach frequently used in DTTs

| Approach | General implication |
|---|---|
| Provide for competent authorities to engage in the reciprocal exchange of information. | DTTs permit information to be exchanged to the widest possible extent with a view to laying the proper basis for the implementation of domestic tax laws and for the application of specific DTT provisions. The information that can be provided includes information about non-residents and other taxes (beyond capital and income). |

*Source:* UNCTAD.

## Takeaways for investment policymakers: reform and expansion of EOI mechanisms

Despite broad agreement on the importance of EOI and its inclusion in DTTs, progress towards effective tax transparency has met significant obstacles in the past. Pre-BEPS, the ineffective exchange of information posed a challenge. One of the priorities of BEPS Action 5, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, was, hence, to improve transparency, including spontaneous EOI (OECD, 2015b). In particular, the Forum on Harmful Tax Practices aimed to improve transparency on tax rulings that include any advice, information or undertaking provided by a tax authority which a specific taxpayer or group of taxpayers are entitled to rely on. The Forum sought to establish a framework for compulsory spontaneous EOI in respect of rulings related to preferential tax regimes and to improve spontaneous exchange on tax rulings that caused BEPS concerns.

The BEPS project identified tax transparency as one of its pillars, recognizing that BEPS could be prevented only by eliminating the information asymmetries between taxpayers and tax authorities. Several Actions seek to deal with information asymmetry by various means:

- Improving the availability and analysis of data on BEPS
- Ensuring better information flows between tax administrations
- Ensuring that timely, targeted, and comprehensive information is available
- Improving disclosures by taxpayers
- Providing comprehensive and relevant information on tax planning strategies
- Providing improved transfer pricing documentation

Although efforts are being made to improve this broad policy framework to facilitate tax transparency, the administrative aspects of EOI continue to be an area of concern, especially in developing countries. The UNTC has identified that many developing countries still do not have extensive treaty networks, limiting the number of countries with which they can exchange information (Committee of Experts on International Cooperation in Tax Matters, 2021). In addition, even among those that are members of the Global Forum and have ratified the MAATM, many do not fully utilize the agreement and only a limited number of requests for information have so far been made by developing countries. There are several reasons for this, including limited technical capacity and human resources.

### Table 20. Post-BEPS approach frequently used in DTTs

| Reform options | General implication |
|---|---|
| Provide technical assistance to improve the administrative capacity among developing and least developed countries to engage in effective EOI. | This is one of the most fundamental aspects of reform to improve international tax transparency frameworks. Investment policymakers should encourage the strengthening of technical capacity in EOI as part of ensuring that the country and any preferential tax regimes are not viewed as harmful for lacking EOI. |
| Expressly provide for the possibility of sharing information by tax authorities with other law enforcement agencies and judicial authorities if certain conditions are met. | This is key in enabling interagency cooperation to combat financial crimes. The financial integrity of the national system remains an important aspect of investment attractiveness that should concern policymakers. |

*Source:* UNCTAD.

# CONCLUSION

The tax and investment policy communities share broader common objectives: promoting investment and mobilizing resources for sustainable development. Two extensive networks of treaties exist for double taxation and foreign investment protection respectively. As these networks interact and are subject to ongoing reform efforts, each community needs to understand the basic principles that underlie both types of agreements.

This guide for investment policymakers and the related guide for tax policymakers (UNCTAD, 2021) are intended to help develop a common understanding of the terms and concepts in both types of treaties and thereby to provide the basis for an intensified dialogue between the two communities. Coordination between tax and investment policymaking could help increase coherence and accelerate the reform processes that are taking place at the national, bilateral, regional and international levels.

The BEPS Project resulted in wide-ranging changes to the international tax landscape. As a result of the OECD two-pillar solution to address the tax challenges arising from the digitalisation of the economy, fundamental changes to the international tax system continue to be implemented. This has significant impacts on investment. In addition to the global minimum tax for large enterprises other changes take place. Source States are allocated taxing rights with respect to the income of enterprises that do not have a physical presence in the country. Under the STTR taxing rights for source States on income that is subject to no or low taxation in the residence State are introduced. These changes will have a significant impact on investment and therefore investment policymakers should closely follow the progress of the proposed amendments.

The reform of the IIA regime, taking place in parallel, can help safeguard policy space for tax policies and public policy measures. It is important for the tax and investment policymakers to consider the implications of IIAs for tax measures, including the risk of tax-related investor–State arbitrations and options to limit States' legal exposure through treaty reforms.

The tax community has recognized in recent years that the MAP process under DTTs needs to be improved. Considerable progress has been made by the G20/OECD initiatives. However, more can be done to strengthen tax dispute avoidance and resolution mechanisms, including the design of mediation and arbitration processes that address the legitimate concerns of developing countries. This objective is shared between the tax and investment communities.

Both communities can contribute their respective expertise to accelerate reforms of the investment and tax policy environments.

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