

August 2017

Tax Treaty Models - Past, Present, and a Suggested Future

Doron Narotzki

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Recommended Citation

Narotzki, Doron (2017) "Tax Treaty Models - Past, Present, and a Suggested Future," *Akron Law Review*: Vol. 50 : Iss. 3 , Article 1.

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TAX TREATY MODELS—PAST, PRESENT, AND A SUGGESTED FUTURE

*Doron Narotzki**

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I. INTRODUCTION

Nations rely on taxes to fund their activities and services. Because each nation’s tax revenue is predominantly generated from domestic sources, the right to tax is clearly of domestic origin. However, the current state of trade relations involves multinational and foreign corporations, as well as aspects of international law. As a result, two critical questions are which of the parties in an international transaction should be taxed, and of course, how should they be taxed?

One of the main purposes of the international tax field is to allow and incentivize individuals and corporations to conduct business with other countries. These cross-border transactions involve more than one country and therefore, more than one tax regime. To avoid situations of double taxation and even those of non-taxation, nations develop, negotiate, and ultimately sign tax treaties. Once this process is concluded, the two signatory nations agree on how to allocate taxes for “different types of income.”¹

There are two basic and fundamental international tax bases: the territorial (source) base, which capital exporter nations negotiate for in treaties, and the resident base, negotiated for by capital importers. A nation first needs to understand its best tax policy to obtain and optimize a treaty. Second, it must understand how to implement this policy. To do so, those drafting this policy must know the other nation’s needs and be familiar with every tax treaty model and current tax treaties. This paper will focus mostly on the United States’ tax treaties, and the evolution that the United States has experienced while transforming from a capital exporter to a country that imports as much as it exports. This will then be compared to an analysis of China’s tax policy as well as the tax policies of a few Latin American countries to determine whether there is a need for change in the United States.

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1. See H.L. Goldberg, *Conventions for the Elimination of International Double Taxation: Toward a developing Country Model*, 15 LAW & POL’Y INT’L BUS. 833 (1983); Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT’L L. & POL. 939 (2000).

II. THE EVOLUTION OF TAX TREATIES

From the year 1919 through 1935, as a result of significant increases in the number of international transactions, organizations such as the International Chamber of Commerce (ICC) and the League of Nations appointed groups to study, analyze, and fight the issues of double taxation and tax evasion.² The workings of such organizations led to the development of a system of credits, which established how to assign taxing jurisdictions on the basis of “economic allegiance.”³ In 1928, three model conventions were released (1928 Model Conventions) which later became the standard for treaty discussions and even the basis for the evolution of many initial U.S. tax treaties.⁴

Less than twenty-five years later, the 1943 Mexico Model Tax Treaty replaced the 1928 Model Conventions at the 1940 Fiscal Committee Conference. This new model was intended to promote the use of tax treaties between developing and developed countries. This model was consistent with the general principle of taxing income at its source.⁵ However, the new treaty policy was widely unaccepted by developed countries, so, in response, the 1946 London Model Convention was drafted.⁶ The amended model, created by European members, attempted to encourage investments in developing countries, specifically in Latin America.⁷ The main changes were as follows: (1) the taxing rights over interests, dividends, annuities, and royalties were given to the country of residence;⁸ and (2) the nonresident entity’s business profits were subjected to source-based taxation only if it had a permanent establishment in that source country.⁹

In 1956, the Organization for European Economic Cooperation

2. Mitchell B. Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad: Part I*, 2 INT’L TAX LAW 692, 698 (1968); see U.N. Dep’t of Int’l Econ. & Soc. Affairs, U.N. Model Double Taxation Convention Between Developed and Developing Countries at xv, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. MODEL].

3. BRUINS ET AL., REPORT ON DOUBLE TAXATION SUBMITTED TO THE FINANCIAL COMMITTEE LEAGUE OF NATIONS (1923), <http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default>.

4. See H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT’L L. 359, 365 (1981).

5. Carroll, *supra* note 2, at 708.

6. Fiscal Committee, London and Mexico Model Tax Conventions for the Prevention of Double Taxation of Income and Property, League of Nations Doc. C.88.M.1946.II.A (1946) [hereinafter London–Mexico Model Tax Convention].

7. U.N. MODEL, *supra* note 2, at xii.

8. London–Mexico Model Tax Convention, *supra* note 6, at 63–67.

9. *Id.* at 61.

(OEEC), which was replaced by the Organization for Economic Cooperation and Development (OECD)¹⁰ in 1961, began to form its own committees in order find a way to deal with the issue of double taxation. The 1977 Model Convention, the OECD Model Tax Convention on Income and Capital (OECD Model), built upon the developments made by the ICC and League of Nations, quickly emerged as the benchmark for tax treaties all over the world.¹¹

In 1980, the first U.N. Model Double Taxation Convention between Developed and Developing Countries (U.N. Model) was released.¹² Although based largely on the 1977 OECD Model, the U.N. Model, which was quickly embraced by developing countries, granted more taxation rights to the source state, or capital importing country, than the OECD Model.

The OECD published updates in 1992, 1994, 1995, and 1997 to its treaty model. In 2001, a new U.N. Model was published to account for the growth of the “globalization of trade and investment” since 1980.¹³ The OECD again published updates in 2003, 2005, 2008, and 2010. From an international point of view, these two models are the primary standard for tax treaties. However, some countries, the United States being the most notable, have their own models which they aspire to utilize.

A. *Historical Development of the U.S. Model (1963 through 1976)*

Since the 1930s, when the United States entered its first comprehensive tax treaty,¹⁴ all U.S. tax treaties were based upon the U.S. Model Income Tax Convention (U.S. Model),¹⁵ which the Treasury

10. The legal entity of the OEEC was replaced and continued by the OECD, which came into being on September 30, 1961; see HISTORY OF THE OECD, OECD (2015), <http://www.oecd.org/general/historyoftheoecd.htm>.

11. Bart Kusters, *The United Nations Model Tax Convention and Its Recent Development*, 4 ASIA-PACIFIC TAX BULL. (2004).

12. Michael Lennard, *The Purpose and Current Status of the United Nations Tax Work*, 14 ASIA-PACIFIC TAX BULL. 24, 25 (2008).

13. U.N. MODEL, *supra* note 2, at xii.

14. The U.S. entered its first comprehensive tax treaty with France in 1932. The treaty did not come into effect until 1935; see E. M. McCaffery, *The Franco-American Convention Relative to Double Taxation*, 36 COLUM. L. REV. 382 (1936).

15. I.R.S., U.S. MODEL TECHNICAL EXPLANATION ACCOMPANYING THE U.S. MODEL INCOME TAX CONVENTION OF 2006, <https://www.irs.gov/individuals/international-taxpayers/the-u-s-model-income-tax-convention-and-model-technical-explanation> [hereinafter U.S. MODEL]; see Wm. L. Burke, *Report on Proposed United States Model Income Tax Treaty*, 23 HARV. INT'L L. J. 219, 220 (1983); see also Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW. 1, 4 (1986); see also H. David Rosenbloom, *Current Developments in Regard to Tax*

developed throughout the course of treaty negotiations with various states. Once the OECD published its first version of the Treaty Model in 1963, many countries began to rely on the OECD Model while negotiating tax treaties. Gradually, the U.S. Treasury experienced an increase in resistance toward the model it had been using, which had not yet been published or otherwise officially acknowledged. The structure, terminology, and content of this unofficial model were unfamiliar to most foreign countries, as it varied greatly from the OECD Model.¹⁶ Rather than explaining the divergent U.S. terminology during negotiations with each individual treaty partner, the Treasury gradually began to conform to the customs set forth by the OECD Model. This trend became apparent in the early 1960s¹⁷ and peaked in 1975 with the conclusion of the U.S.–U.K. tax treaty.

In spite of this coalescence between models, the OECD Model did not replace the unofficial U.S. Model. Instead, the Treasury decided to publish its own model and created the official U.S. Model, the first official version of which was released on May 18, 1976.¹⁸ Although never officially stated, it appears the main reason that the U.S. Treasury adhered to the OECD Model was due to the understanding that the United States was no longer in a position to keep expanding its tax treaty network without adopting the dominant structure and terminology that most countries followed during negotiations.¹⁹ Also, because the United States wanted to emphasize residence state taxation in its model, adopting the OECD Model simplified this goal because the OECD

Treaties, 40 N.Y.U. TAX INST. 31, 31-56 (1982).

16. Rosenbloom, *supra* note 15, at 31-62.

17. Convention Between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.–L.U., art. V, Apr. 3, 1996, 2148 UNTS 81 [hereinafter U.S.–Luxembourg Treaty] (following the Permanent Establishment definition of the OECD Model and adopts certain concepts regarding taxation of permanent establishment). *See also* Convention between the Government of The United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.–F.R., Nov. 27, 1956, 7 UST 3405 [hereinafter U.S.–France Treaty]; the Convention between The United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–B.E., art. V, July 9, 1970, 3 UST 5245 [hereinafter U.S.–Belgium Treaty].

18. Administrative Law, 41 Fed. Reg. 20, 427 (1976) (announcement of U.S. Model). *See also* Burke, *supra* note 15, at 224.

19. Rosenbloom, *supra* note 15. *See also* *Income Tax Treaties: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 96th Cong. 71 (1980) [hereinafter *Income Tax Treaties*] (Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury).

Model emphasized the same tax policy. Since then, both the OECD and United States have published new versions of their models.

The drafting and publishing process of the U.S. Model serves two purposes. First, the model is intended to offer a “uniform starting point” for any U.S. treaty negotiations.²⁰ In typical treaty negotiations, before the actual discussions get underway, the United States forwards the U.S. Model to the potential treaty partner, which serves as a draft for the “first round” of negotiations.²¹ Based upon this first draft, specific problem areas are then addressed and amended. Past experiences have shown that the Treasury is willing to alter provisions of the U.S. Model, especially while negotiating with developing countries.²²

The second purpose of the U.S. Model is to promote extensive harmonization of U.S. treaties with the OECD Model.²³ In drafting the official U.S. Model (rather than the unofficial model released prior), the Treasury sought to minimize the differences between the U.S. Model and OECD Model that had little or no substantive importance.²⁴ Therefore, the topics in the U.S. Model that diverge from the OECD Model highlight important aspects of U.S. tax treaty policy. It should be noted that both purposes have been criticized.²⁵ As for the first, some researchers believe that viewing the U.S. Model as the “first offer” for every tax treaty negotiation places unnecessary limitations on the flexibility of tax treaty negotiations and drafting procedures. These researchers claim that if the U.S. Model constitutes a “first offer”—a benchmark for a treaty negotiations process—then the United States delegation could be forced to accept certain provisions that are inappropriate in the context of the negotiations with a particular country. Of course, this must have been taken into consideration at some point during the U.S. Model drafting process; thus, this model does not provide a neutral, accurate portrait of U.S. tax treaty policy, but rather the most favorable starting point for U.S. tax treaty negotiations.

It has been suggested, both here and by other commentators, that

20. See Vogel, *supra* note 15, at 13; *International Tax Treaties: Hearing Before the Senate Comm. on Foreign Relations*, 96th Cong. 115 (1979) [hereinafter *International Tax Treaties*] (David C. Lubick, Assistant Secretary of the Treasury for Tax Policies, Responses to Additional Questions for the Record) (“The U.S model income tax convention was developed to provide a uniform starting point for U.S. income tax treaty negotiations and to conform U.S treaties as closely as possible to the model income convention of the OECD.”). See also *Income Tax Treaties*, *supra* note 19, at 70.

21. *International Tax Treaties*, *supra* note 20, at 103.

22. *Id.*

23. *Id.* at 105.

24. *Income Tax Treaties*, *supra* note 19, at 71.

25. Burke, *supra* note 15. See also Rosenbloom, *supra* note 15.

the U.S. Model should be viewed as the ultimate goal that the United States would like to reach in its tax treaty negotiations. According to this view, in terms of the U.S. tax treaty policy, the U.S. Model should signify an ideal treaty, as opposed to just the starting point for actual treaty negotiations.²⁶ Critics of this suggestion say that it results in a lack of flexibility during negotiations, as every change in the model will be seen as taking a step back from an ideal tax treaty.

Also, drafting the U.S. Model to foster extensive conformity between U.S. tax treaties and the OECD Model may have been criticized because many of the provisions in the first OECD Model were drafted prior to the year the United States joined and became a member of the OECD.²⁷ Moreover, the United States did not always participate in drafting the OECD Model. Therefore, the issue of whether the OECD Model truly represents the U.S. tax treaty interests arises as, traditionally, the U.S. had its own “peculiarities” in its tax treaty policy and approach.²⁸

Nonetheless, the most important decision the Treasury made while drafting the U.S. Model was whether the structure and the content of their model should be altered to conform to that of the OECD Model, or continue on the path of divergence.²⁹ This decision was necessary to further expand the U.S. treaty network, largely due to the fact that all other countries were relying on the OECD Model as their basic reference document for drafting tax treaties.³⁰ As a result of the decision to conform, the U.S. Model parallels the structure of the OECD Model, as even the individual articles of the U.S. Model cover principally the same issues as those in the OECD Model. To a significant extent, the models also correspond in terms of content. In addition to adopting the structure of the OECD Model, the U.S. Model also adopted the OECD terminology and the formulations of many individual provisions. However, since the U.S. tax treaty policy was not exactly the same as the OECD tax treaty policy, a complete adoption of the OECD was not possible.

Theoretically, these tax treaty models are meant to reflect each specific country’s tax policy. However, as we often see in taxation and other areas of life, a country’s tax policy may change frequently as a matter of short-term political agendas and various other reasons. For

26. Burke, *supra* note 15.

27. The U.S. joined the OECD in 1961.

28. Vogel, *supra* note 15.

29. *Income Tax Treaties*, *supra* note 19, at 77.

30. *Id.*

example, many expect that newly-elected President Trump's administration will have a completely different policy and approach towards international trade and multinational corporations. Any type of tax reform or change to the code may reflect a completely different approach than President Trump's predecessors. Therefore, these specific models may not best reflect a country's long-term tax policy.

This paper suggests that policy makers, specifically tax policy makers, need to identify their country's best tax policy that on its face serves the country's long-term interests, so that their proposed tax treaties will not change as frequently and will be implemented in practice, not just in theory. Once again, to identify the right tax policy, we need to go back to the basics, which means identifying the purpose of tax treaties.

B. U.S. Model Income Tax Treaty Update (2016)

In May 2015, the United States Treasury Department released a document containing proposed revisions to the U.S. Model. Many of these revisions were recommended in order to help prevent the issue of base erosion and profit shifting (BEPS) of multinational corporations. As the international tax environment continues to evolve, individual tax regimes also change and develop. This evolution of various tax regimes could enhance BEPS within such countries, which is a significant concern for the U.S. Treasury Department. Thus, to continuously oppose instances of BEPS and set a benchmark for other treaty negotiations, the Treasury issued proposed changes to ensure the United States would be "able to maintain the balance of benefits negotiated under its treaty network" as well as "deny treaty benefits to companies that change their tax residence in an inversion transaction."³¹ It is important to note that once finalized, the proposed changes must be implemented into existing treaties before becoming effective due to the fact that the Model is not self-executing.³²

The OECD has also been working to combat BEPS. and in October

31. Press Releases, Treasury Releases Select Draft Provisions for Next U.S. Model Income Tax Treaty, United States Department of Treasury (May 2015), <http://www.treasury.gov/press-center/press-releases/Pages/j110057.aspx>.

32. US TREASURY PROPOSES FUNDAMENTAL CHANGES TO US MODEL INCOME TAX CONVENTION: OVERVIEW, PRICEWATERHOUSECOOPERS (May 21, 2015), <http://www.pwc.com/us/en/tax-services/publications/insights/us-treasury-proposes-changes-us-model-income-tax-convention.html>; US PROPOSES MAJOR REVISIONS TO MODEL TAX TREATY TO COUNTER BASE EROSION, ERNST & YOUNG (May 29, 2015), <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert—US-proposes-major-revisions-to-model-tax-treaty-to-counter-base-erosion>.

of 2015 it released the Base Erosion and Profit Shifting 2015 Final Report (BEPS Report).³³ In fact, the release of the proposed changes for the first set of U.S. Model revisions has been thought to be an attempt to influence the BEPS Report³⁴ and keep the United States involved in such international conversations. Both reports look to decrease the occurrences of “stateless income” or double non-taxation in special tax regimes.³⁵ A special tax regime, as defined by the Treasury, is aimed to provide low tax rates on specific types of income in various countries, especially mobile income that is easy to shift from one location to another. Specifically, paragraph 1(l) of Article 3 was recommended to be modified to address special tax regimes.³⁶

Another way the Treasury has looked to deter BEPS is by eliminating treaty shopping by third-countries due to the presence of a Permanent Establishment (PE) located outside the treaty country. This objective would modify the current Article 1, paragraph 7. This modification applies if the profits derived from the PE are subject to less than sixty percent of tax than the applicable tax rate in the residence state and the country where the PE is located that does not have a tax treaty with the United States. In turn, this alteration would directly affect the current “triangular provisions” of U.S. tax treaties and would not allow for preferential rates (i.e., fifteen percent) for dividends, interest, and royalties.³⁷

In certain instances, however, it may be appropriate for third-countries to receive some benefits, such as when the income from a PE is included in the tax base of a residence state.³⁸ To recognize the

33. BASE EROSION PROFIT SHIFTING 2015 FINAL REPORT, ORGANIZATION OF ECONOMIC COOPERATION (October 5, 2015), <http://www.oecd.org/ctp/beps.htm>.

34. BASE EROSION PROFIT SHIFTING 2015 FINAL REPORT, ACTION 5: COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY, ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT (October 5, 2015); BASE EROSION PROFIT SHIFTING 2015 FINAL REPORT, ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS INAPPROPRIATELY, ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT (October 5, 2015).

35. *Id.* See Michael H. Radolinski, *U.S. Treasury Attempts to Influence OECD’s BEPS Initiative via Proposed Changes to U.S. Model Treaty*, OSLER (June 22, 2015), <https://www.osler.com/en/resources/regulations/2015/u-s-treasury-attempts-to-influence-oecd-s-beps-in>; *Treasury Releases Select Draft Provisions for Next U.S. Model Income Tax Treaty*, *supra* note 31.

36. US TREASURY PROPOSES FUNDAMENTAL CHANGES TO US MODEL INCOME TAX CONVENTION, *supra* note 32.

37. See TREASURY RELEASES DRAFT AMENDMENTS TO THE 2006 U.S. MODEL INCOME TAX CONVENTION, DELOITTE (July 10, 2015), <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-unitedstates-10-july-2015.pdf>; US TREASURY PROPOSES FUNDAMENTAL CHANGES TO US MODEL INCOME TAX CONVENTION, *supra* note 32.

38. *Id.*

relevance of subsidiary corporations involved with treaty nations, the implementation of a “derivative benefits” rule has been proposed to expand conceptual ownership in the case of “equivalent beneficiaries”³⁹ that meet a base erosion test.⁴⁰ This modification is one of the many recommended changes to Article 22, the Limitation on Benefits (LOB), of the current U.S. Model. Other variations include a restriction on attribution of activities under the active trade or business (ATB) test and a substantial nontax nexus for purposes of discretionary relief.⁴¹

The Treasury also looked to decrease the benefits received through corporate inversions. The revisions looked to employ a system that implements withholding taxes on certain crucial payments⁴² made by “expatriated entities,”⁴³ affecting Articles 10, 11, 12, and 21 of the current U.S. Model. There is a possibility that this revision could be limited to payments made amongst related parties.⁴⁴

Along with the other proposed modifications, a new Article 28, Subsequent Changes in Law, was considered for addition as well, which would allow provisions of certain articles (specifically 10, 11, 12, and 21) to “cease to have effect” if the general tax rate of the contracting state drops beneath fifteen percent.⁴⁵ This proposal also surfaced in the BEPS Report, Article 6, in regards to treaty abuse.⁴⁶ The Treasury was also anticipated to include a new article in the finalized update to “resolve disputes between tax authorities through mandatory binding arbitration.”⁴⁷

39. “Defined as either (i) a resident of any state if entitled to benefits under a comprehensive US tax treaty that would be no worse than those being claimed if that resident had received the income directly, or (ii) a qualified resident of the taxpayer’s residence state;” US TREASURY PROPOSES FUNDAMENTAL CHANGES TO US MODEL INCOME TAX CONVENTION, *supra* note 32, at 3.

40. Press Releases, *supra* note 31; *US Treasury proposes fundamental changes to US Model Income Tax Convention*, *supra* note 32, at 3. The base erosion test would require “each intermediate owner between the tested company and the public company to be a resident of either state.” US TREASURY PROPOSES FUNDAMENTAL CHANGES TO US MODEL INCOME TAX CONVENTION, PRICEWATERHOUSECOOPERS (May 21, 2015), <http://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-us-treasury-proposes-changes-us-model-income-tax-convention.pdf>.

41. TREASURY RELEASES DRAFT AMENDMENTS TO THE 2006 U.S. MODEL INCOME TAX CONVENTION, *supra* note 37, at 7.

42. E.g., dividends and base-stripping payments such as interest and royalties. *See id.*

43. I.R.C. § 7874(a)(2) (2005).

44. US TREASURY PROPOSES FUNDAMENTAL CHANGES TO US MODEL INCOME TAX CONVENTION, *supra* note 32, at 3.

45. *Id.* at 4.

46. KPMG REPORT – PROPOSED REVISIONS TO U.S. MODEL TREATY, KPMG LLP (June 10, 2015), <http://www.kpmg.com/us/en/issuesandinsights/articlespublications/taxnewsflash/pages/2015-1/kpmg-report-proposed-revisions-to-us-model-treaty.aspx>.

47. *Treasury Releases Select Draft Provisions for Next U.S. Model Income Tax Treaty*, *supra* note 31.

After leaving the proposals open to recommendations and comments from the public, the Treasury modified these revisions and released the new U.S. Model on February 17, 2016.⁴⁸ The final version does not “reduce withholding taxes on payments of highly mobile income” with regard to special tax regimes, but it does take measures to penalize companies that invert by disallowing a reduction in withholding taxes on payments sourced to the United States.⁴⁹ Furthermore, an article has been included which requires the partners of each respective treaty to revise and amend the document as needed for changes in domestic law that may affect treaty benefits.⁵⁰ Rules have also been added that require mandatory arbitration in the case of “disputes between tax authorities,”⁵¹ and the LOB provision was revised, as expected.⁵² Specifically, for the “active trade or business” test, the Treasury is open to comments through April 18, 2016 with regards to the technical explanation of this provision.⁵³ Remarkably, no changes were made to the PE. Any changes were originally intended to be included in the PE, as well as notably covered in the BEPS Report.

Concern has been raised that the updates will potentially cause an inconsistent application of the rules presented and thus lead to uncertainty for taxpayers. Consultants, such as PricewaterhouseCoopers (PwC), have recommended implementing changes through legislation as opposed to using the U.S. Model. Historically, it has been noted that the suggestion of increased withholding rates has caused more barriers to trade than it has helped to combat harmful tax practices.⁵⁴

48. Press Releases, Treasury Announces Release of 2016 U.S. Model Income Tax Treaty, United States Department of Treasury (February 17, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0356.aspx>.

49. *Id.*

50. Insights, *New U.S. model income tax treaty (2016) is released*, KPMG LLP (February 17, 2016), <https://home.kpmg.com/xx/en/home/insights/2016/02/tnf-us-model-income-tax-treaty-2016.html>.

51. *Id.*

52. Kevin Colan & Paul Seraganian, *U.S. Treasury Releases New Model Tax Treaty*, OSLER (February 22, 2016), <https://www.osler.com/en/resources/regulations/2016/u-s-treasury-releases-new-model-tax-treaty>.

53. PREAMBLE TO 2016 U.S. MODEL INCOME TAX CONVENTION, UNITED STATES DEPARTMENT OF TREASURY (February 17, 2016), <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf>.

54. PWC COMMENT LETTER ON UNITED STATES MODEL TREATY, PRICEWATERHOUSECOOPERS (September 29, 2015), <http://www.pwc.com/us/en/tax-services/publications/insights/pwc-comment-letter-on-united-states-model-treaty.html>.

III. ANALYZING THE TAX TREATY MODELS

A. *Comparative Analysis of the U.S. Model, OECD Model, & U.N. Model*

It is no surprise that the U.N. Model and the U.S. Model are based on the OECD Model, since the latter has been the foundation for tax treaties since its implementation in 1977. As a result, the differences between the models are not significant and the basic principles and structures are almost identical.

The fact that all three models include the same format, syntax, and concepts is one of the main reasons that tax treaties are a staple within global commerce; it creates a “universal language” and bridges different countries, allowing them to “interact” with one another and solve problematic issues concerning business practices and taxation in a relatively efficient way.

Nevertheless, there are differences between the models, arising mostly from the differing policies each entity strives to implement. The OECD Model acts under the general assumption that there is a rough parity of trade and capital flows between countries, and gives relief for double taxation by reducing the tax in the source country where the income was produced. On the contrary, the U.N. Model takes into account special circumstances of developing countries and promotes tax sparing. Also, it is somewhat easier for foreigners to have a PE in the source country.⁵⁵ The U.N. Model chooses to leave reductions of withholding rates to bilateral negotiations, which usually leads to higher withholding rates.

Although it is largely consistent with the OECD Model, there were some issues upon which the U.S. Model could not compromise. These issues are:⁵⁶

1. The “Saving Clause,” where the United States reserves the right to tax U.S. citizens as if the tax treaty does not exist.

55. Within the tax treaty context, the concept of Permanent Establishment (PE) is of extremely significant importance and is oftentimes crucial. PE has been used as an indication of the substantial and long-term presence of a non-resident enterprise in the source state. Only if the activities of a non-resident enterprise have reached the threshold of a PE in the source state can this enterprise be regarded as a participant in the economy of the source state to an extent that the source state can, and often will, claim taxation on business income of that non-resident enterprise. See G.S. Turner, *Permanent Establishments, and Interprovincial Income Allocation: Reflections on the Advisory Report on Electronic Commerce*, MONDAQ BUSINESS BRIEFING (1998).

56. Brauner Yariv, *Why Does the United States Conclude Tax Treaties? And Why Does it not Have a Tax Treaty With Brazil?*, 26 REVISTA DIREITO TRIBUTARIO ATUAL 109 (2011) (in Portuguese).

2. Consistent refusal to allow effective management to dominate the corporate residence rules.
3. Increased emphasis on reciprocity, particularly concerning effective exchange of information.
4. Refusal to include “Tax Sparing” in its tax treaties.
5. Insistence on including a “Limitation on Benefits” clause as a backstop to the regular residence rules.

A deeper analysis will show that the OECD Model actually, in time, accepted most of these issues.

B. *The Objectives of Tax Treaties*

The main objectives of tax treaties are reducing double taxation,⁵⁷ preventing excessive taxation, and helping minimize tax avoidance through exchange of information.⁵⁸ However, oftentimes another reason for signing a tax treaty is “tax sparing.” National tax systems often use some type of tax or other fiscal incentives to “attract investments in specific industries or geographical areas.”⁵⁹ Conversely, these incentives may be minimized or even eradicated by the taxing jurisdiction in the investor’s resident country.⁶⁰ The reason for this elimination is that a reduction of source-country tax is simply compensated for by an increase in the tax imposed by the country of residence because the creditable foreign tax is diminished. As a result, the tax benefit that was originally intended to encourage foreign investments ends up in the country of residence of the foreign investors. Obviously, this is not the outcome countries are seeking. To prevent this from happening in developed countries, tax treaties with developing countries allow foreign tax credits where the tax at the source country was reduced or even eliminated, as if it was collected in full.

57. John Prebble, *The General Principle, Effects and Structure of Tax Treaties*, 10 ASIAN PACIFIC TAX AND RES. CENTRE BULL. 555, 556 (1992); Rosenbloom, *supra* note 15; CHARLES H. GUSTAFSON & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, 1991-1993, 451 (COMMERCE CLEARING HOUSE, 1991); Rosenbloom & Langbein, *supra* note 4, at 365-66.

58. *Treaties: Hearing Before the Comm. on Foreign Relations*, 108th Cong. 11 (2004) (statement of Barbara M. Angus, Treas. Int’l Tax Counsel) [hereinafter Angus Testimony]; *see also* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 1-13 (THE INSTITUTE 1992).

59. *See* OECD, *Making Reforms Succeed: Moving Forward with the MENA Investment Policy Agenda*, 233 (OECD Publishing 2008).

60. Dagan, *supra* note 1, at 995.

C. *Structure of Tax Treaties*

All treaty models follow the same basic blueprints. First, treaties provide rules that detail situations in which a taxpayer would be a resident of each contracting state under each state's domestic law. Second, a system is set up for default allocation rules, where either the residence state or the source state is given the "primary right" to tax income, and the other state either gives up its right to tax entirely or preserves a "residual right" to tax. The right to tax income is determined by its classification.⁶¹ In general, tax treaties usually allocate more tax jurisdiction to the residence state. On the other hand, when no tax treaty exists, the source state generally has a primary right to tax, with the residence state having a residual tax right and a "unilateral obligation to relieve any resulting double taxation."⁶² With the implementation of a treaty, both parties to the agreement are mutually obligated to counter the issue of double taxation. At the same time, "excessive taxation" is avoided by decreasing the amount of source withholdings to the other parties' residents.⁶³ The policy behind all of this is simple: to minimize or even eliminate any tax issue that may discourage individuals or corporations from engaging in cross-border transactions.

Each of the treaty models mentioned before, although written following the same pattern, represents a different international tax policy. This paper will discuss two main points for change that will likely benefit current tax treaties. First, the traditional way of thinking is no longer accurate within the current business environment, and the best policy for a capital exporter or a capital importer country should be followed. Second, in some cases, countries should adopt more than one policy to serve their national interest, depending on specific economic characteristics.

IV. RETHINKING BASIC FUNDAMENTALS IN TAX TREATIES

When dealing with tax treaties, it becomes apparent that there are some terms that are inaccurate, obsolete, or misleading. As a result, using and accepting these terms "as is" may dissuade tax policy makers and scholars from using tax treaties in a more efficient manner.

Often, when tax scholars and practitioners talk about tax treaties, they use the terms "developed countries" and "developing countries"

61. Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX L. REV. 65, 69-71 (2005).

62. *Id.*

63. *Id.*

when attempting to pinpoint an economy or country's preferred tax treaty model. This paper suggests that these terms are not only biased, but also not completely accurate in the contemporary business environment.

One of the problems with the use of the terms "developed countries" and "developing countries" is that they are vague and unclear. For example, the OECD has claimed since its inception in the 1960s to represent developed countries and accept only these countries as members. If this claim is accurate, how can Greece, Turkey, and Mexico be members of the OECD? If these countries are not developed countries, based on what this term actually means, can they decide not to use the OECD Model for their tax treaty negotiations because they are not developed countries based on what developed definitionally means?

According to the United Nations, "[t]he designations of 'developed countries' and 'developing countries' are intended for statistical convenience and do not necessarily express a judgment about the stage reached by a particular country or area in the development process."⁶⁴ Moreover, the commonly accepted definition of a developed country from the U.N. is that "a developed country is one that allows all its citizens to enjoy a free and healthy life in a safe environment."⁶⁵ This definition is confusing at best and maintains its previous uncertainty. Even if the correct definition is clear, the designation has nothing to do with any country's tax policy or economic needs.

This paper suggests using more specific, although still not completely comprehensive, definitions such as "capital exporter" or "capital importer" to describe countries. This definition is based upon clean, hard data and cannot be based upon biased opinion or influenced by subjective information and agendas. However, although these definitions are better than the ones traditionally used, they are still not completely accurate, as mentioned in the opening of this paragraph. In some cases, these terms can still cause issues when properly describing the situation and including all the necessary data and information.

The fact that some countries are not pure capital exporters or pure

64. See Department of Economic and Social Affairs: Population Division, *World Population 2015*, UNITED NATIONS (2015), http://esa.un.org/unpd/wpp/Publications/Files/World_Population_2015_Wallchart.pdf; Department of Economic and Social Affairs: Population Division, *World Population Policies*, UNITED NATIONS (2013); *Terms and Conditions*, UNITED NATIONS POPULATION FUND (2008), <http://web.unfpa.org/public/cache/offonce/home/pid/3802>.

65. Press Release, In Address to UNDP Resident Coordinators, Secretary-General Stresses Need for "Experiment and Creativity" in Development Efforts, UN Press Release SG/SM/7316 DEV/2232 (Feb. 28, 2000).

capital importers in the new business environment can cause even these rephrased definitions to become inaccurate. Rather, in some types of industries such as manufacturing, countries are capital importers and, in others, they are capital exporters. By using this clear and significant distinction obtained through essential analysis, it is apparent that countries will have a completely different economic interest depending on with which country they wish to negotiate and sign a tax treaty.

V. THE NEED FOR CHANGE IN THE U.S. TAX TREATY POLICY

A. *Changes in the U.S. Economy*

Until the 1980s, most manufacturing was what is referred to today as “traditional manufacturing,” which included mostly, but not solely, tangible assets. Most manufacturing was done in the United States, which made the country become one of the largest capital exporters in the world. Therefore, its tax treaties were drafted in a way that notably reflected this position and provided the maximum deduction given for a Permanent Establishment situated in other countries. This ensured that business enterprises and residents in the United States were able to transfer profit from their Permanent Establishments back to the United States. However, as globalization began taking hold of the business world, technology became less expensive and more sophisticated, and the United States began to import manufactured products for growing consumption, which then created stronger demand for the “manufacturing” of intangible assets.

As a result, the U.S. economy started to transform from a capital exporting country to a country that imports as much as it exports.⁶⁶ The U.S. Census Bureau website has data regarding the U.S. trade of goods and services on a balance of payments basis dating back to the year 1960. During this time, although total trade was significantly under five percent of the total GDP, the United States was exporting more than it was importing. Today, the United States imports more than it exports and trade is closer to twenty-five percent of its total GDP.⁶⁷ This analysis and the attempt to label the type of economy (i.e., whether it is a capital export or capital import economy), becomes increasingly more

66. Organization for Economic Co-operation and Development, *Trends and Recent Developments in Foreign Direct Investments* (2004).

67. Mark Wieczorek, *The US Trade Deficit*, MARK T.A. WIECZOREK (2003), http://www.marktaw.com/culture_and_media/TheUSTradeDeficit.html; U.S. TRADE IN GOODS AND SERVICES – BALANCE OF PAYMENTS (BOP) BASIS, THE UNITED STATES CENSUS BUREAU (2015), <http://www.census.gov/foreign-trade/statistics/historical/gands.pdf>.

complicated when capital import and export rates for individual countries vary drastically.

For instance, although it may appear as though trading with China and Mexico is comparable, a closer look into the import/export ratio shows an important difference in both levels. The United States' trade with Mexico is forty-one percent exports. On the other hand, with China, that amount is only fifteen percent. As a result, this difference must be addressed in the formulation of each tax treaty. In order to incorporate different formulations between different countries, it is important to understand what the most appropriate policy that needs to be implemented into each tax treaty based on the countries involved.⁶⁸

This data raises an important question: due to the changes in its economic structure, what are the United States' real economic interests in tax treaties today?

B. *The U.S. Tax Treaty Policy*

1. Analyzing the U.S. Tax Treaty Policy

In the 1960s, when the United States first became more engaged in tax treaty agreements, its approach was fundamentally structured with a strong preference to residence taxation, since it was one of the world's largest capital exporters. Unfortunately, this unchanged belief ignored the fact that, during the 1980s, the United States became a net capital importer; this should have created a strong reform in every U.S. tax policy. Additionally, to add more complexity to their economic position, the United States remained a large capital exporter economy.⁶⁹ This unaltered tax policy was criticized by notable former officials and tax scholars; for example, twenty years ago, Professor H. David Rosenbloom called for a re-evaluation of the U.S. tax treaty policy, which he found lacking at best.⁷⁰

The concept mentioned above found its place in tax treaties in the pursuit of a maximum residence-based taxation while minimizing, if not eliminating, withholding tax rates. Moreover, this approach does not fit the U.S. historic view that each tax treaty was a separate, independent agreement negotiated with the goal of maximizing benefits received by the United States. It seems like U.S. officials were much more concerned at that time about the evasion of U.S. tax collection from U.S. taxpayers,

68. *Wieczorek, supra* note 67.

69. *Yariv, supra* note 56.

70. *Id.*

rather than foreign residents. This concern is what led to a focus on treaty shopping and exchange of information issues over the last fifty years.

Rosenbloom and Stanley Langbein described four principal periods of U.S. tax treaties.⁷¹ The first period spanned the term of the general U.S. tax treaty which covered items of investment income in the 1942 treaty with Canada. The second, spanning the term of the 1945 U.K. treaty, distinguished between different categories of passive income⁷² and led to the inauguration of a program that included a tax sparing provision.⁷³ The third period consisted of renegotiations of earlier tax treaties to include U.S. approaches such as the “general rule of taxation” and source income. Finally, the last periods are those based on the U.S. Model, since it was first published in 1976 and appears to generally follow the OECD Model.

2. Evaluating the U.S. Tax Treaty Policy

Surprisingly, the U.S.–China tax treaty, which came into effect on January 1, 1987, seems to be based on the U.N. Model more so than any other tax treaty model. For example, Articles 3 (Definitions), 5 (Permanent Establishment), and 7 (Business Profits) are almost identical to the U.N. Model version of that time.

As is consistent with the U.N. Model, Articles 9 (Dividends), 10 (Interest), and 11 (Royalty Income) in the U.S.–China tax treaty favor allocation to the source nation as opposed to the resident nation. However, the maximum rates for dividends in this treaty follows the lead of the U.S. Model, which has a ceiling of five percent on direct dividends and fifteen percent on portfolio dividends. However, the U.N. Model instead allows for negotiation when it comes to the maximum rates. A much broader definition of “royalties” is also included, which is not seen in either the U.S. or U.N. Models.⁷⁴

71. Rosenbloom & Langbein, *supra* note 4, at 374.

72. Convention between the United Kingdom of Great Britain and Northern Ireland and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Apr. 16, 1945, 3 U.S.T. 4158 [hereinafter U.S.–U.K. Treaty].

73. The first tax treaty to introduce such provision was the tax treaty with Pakistan. *See* A Convention between the United States of America and Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Pak., July 1, 1957, 10 U.S.T. 984 [hereinafter U.S.–Pakistan Treaty].

74. Agreement between the Government of The United States of America and the Government of The People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, art. 11, U.S.–P.R.C., Apr. 30, 1984,

By allowing for a broader source-based taxation program, China will receive more of a benefit than if it were to follow the U.S. Model, or even the generally favorable source-based U.N. Model. Thus, the U.S.–China tax treaty is notoriously generous towards China. However, China did not appear to make any unusual negotiations with the United States. For example, many of the provisions, such as the ten percent rate limit on withholding at the source of passive investment income such as dividends, interest, and royalties, resemble very similar provisions made in other treaties like the U.S.–Jamaica tax treaty.⁷⁵ In addition, this amount is the exact same as the provision which China currently has in their treaty with Japan.⁷⁶

There was one area in which the United States and China had strongly opposing views: the tax sparing provision. While China persisted in including a tax sparing credit,⁷⁷ the United States settled the issue by granting China the unique and highly desirable “most favored nation” (MFN) status with regard to any future U.S. tax sparing policy changes.⁷⁸

It is clear that political concerns were a driving force behind the negotiations of this treaty for several reasons. It was first signed by a U.S. president.⁷⁹ It was highly favorable toward taxation at source. And it included many other provisions that favored China. However, there is a known concern in the U.S. that if China pushes the limits in negotiations and attempts to “stack the deck,” other countries will follow China’s lead when drafting tax treaties.⁸⁰ Although negotiations are vital

35 U.S.T. 3819 [hereinafter U.S.–China Treaty]; U.N. MODEL, *supra* note 2, at art. 12; U.S. MODEL, *supra* note 15. In the U.S.–China Treaty, Article 11 specifically includes income derived from the use of films, tapes, and technical know-how. The U.S. Model’s Article 12 excludes films and tapes specifically and omits technical know-how, and the U.N. Model’s Article 12 includes films and tapes, but not technical know-how.

75. The Convention between the Government of The United States of America and the Government of Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Jam., art. 10 – 12, May 21, 1980, 33 U.S.T. 2865 [hereinafter U.S.–Jamaica Treaty].

76. People’s Republic of China–Japan: Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income art. 10–12, 23 I.L.M. 120 (1984) [hereinafter China–Japan Treaty].

77. See Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 UCLA L. Rev. 369, 387 (1987).

78. See Reese, *supra* note 77; U.S.–China Treaty, *supra* note 106 at 1445.

79. *Agreement with China for the Avoidance of Double Taxation: Hearing on Treaty Doc. 98-30 before the Senate Comm. on Foreign Relations*, 99th Cong., 1st Sess. 17 (July 30, 1985) [hereinafter *Senate Hearing*] (statement of Ron Pearlman, Assistant Secretary for Tax Policy, U.S. Department of the Treasury). See also Daily Tax Rep., *Tax Treaties: Senate Foreign Relations Committee Clears Way for Ratification of U.S.–China Agreement*, BNA (1986).

80. Reese, *supra* note 77, at 391.

to ensure continuous positive relations between the U.S. and China, it may be necessary for the United States to implement procedures in order to prevent unfavorable treaty provisions in the future.

One suggestion for improvement is to have the United States create stock treaty models to reflect the various types of potential countries and economies with which the U.S. will negotiate. For example, one of the models could detail negotiations with a third-world country. Additionally, in negotiations, nations should be informed that, in order to conclude a treaty with the United States, any deviation made from the U.S. standard must be countered with concessions of their own.

This paper suggests that the United States delegation team's flexibility should be eliminated. In addition, a higher and more finely tuned adherence to the new proposed treaty model will assist the tax treaty ratification process. From the United States' perspective, cases such as the one ruled upon by the Beijing High Court in 2002⁸¹ should not have occurred. The United States unnecessarily paid over \$1.5 million in taxes due to the flexibility regarding the definitions of royalties. But for the allowed flexibility regarding royalties, the passive royalty income paid by China's CCTV to a U.S. satellite company would have otherwise been classified as business income and thus not taxable in China. Instead, it was subject to seven percent withholding by CCTV.⁸²

VI. CHINA'S ECONOMIC EVOLUTION—A SHIFT IN TAX TREATY POLICY

A. *China—General Introduction*

Shortly after its founding in 1949, People's Republic of China founded a formal tax system in 1950. Since then, China has been able to watch and learn from some of the best practices amidst the development of the business world. Thus, China was able to revolutionize its economy and transform into the international powerhouse that it is today.⁸³

In general, China's taxes are classified into four broad categories: (1) Tax on Industry and Commerce (TIC);⁸⁴ (2) Agricultural and Animal

81. See Ge Tan, *Tax Treaties' Interpretation and Application under the Challenges of the Digital Economy – Issues Raised by PANAMSAT v. Beijing State Tax Bureau*, 16 REVENUE LAW JOURNAL 99 (2006).

82. *U.S.–China Treaty*, *supra* note 74, at art. 11.

83. Daniel H.K. Ho, *Tax Law in Modern China: Evolution, Framework and Administration*, 31 H.K. L.J. 141 (2011).

84. Also known as TIC.

Husbandry Tax; (3) Deed Tax; and (4) Customs Duty. From these taxes, TIC generates a major proportion of total tax revenue and is mainly comprised of turnover and income taxes.

China is quickly becoming one of the largest economies in the world, as well as one of the most popular investment destinations. This was not always the case as, until 1979, China had no foreign direct investment (FDI).⁸⁵ The 1979 economic reform in China created an “open door” policy, which allowed foreign capital enterprises to invest in China. Since the adoption of this policy, many foreign capital enterprises have established some form of presence in China.

As a result of this reformation, China has witnessed incredible economic growth in the last quarter of the twentieth century. According to the State Statistical Bureau, in the twenty-year period of 1979 through 1999, “China utilized \$459.6 billion of foreign capital and attracted foreign direct investments of \$305.9 billion.”⁸⁶ In addition, it was stated that “China received the largest amount of FDI amongst all developing countries between 1992 and 1998.”⁸⁷ At the same time, the Chinese economy went through significant change and transformed from being an isolated economy with limited interaction with global economics into one of the world’s most influential and largest economies.⁸⁸ The aforementioned transformation meant more than just economic growth. It also meant that the Chinese government had to make significant changes and implement strong and efficient international taxes and international trade policies in a relatively short period as well as create, legislate, and sign for the right tax laws and bilateral tax agreements.⁸⁹

The modern Chinese income tax system, which also deals with

85. Jinyan Li, *The Rise and Fall of Chinese Tax Incentives and Implications For International Tax Debates*, 8 U. FLA. TAX REV. 669 (2007).

86. See Daniel H.K. Ho, *International Agreements for the Avoidance of Double Taxation: A Study of China*, 32 HONG KONG L.J. 677 (2002); STATE STATISTICAL BUREAU, CHINA STATISTICAL YEARBOOK OF 1991, 629 (Beijing: China Statistical Publishing House, 1991); STATE STATISTICAL BUREAU, CHINA STATISTICAL YEARBOOK OF 1996, 527 (Beijing: China Statistical Publishing House, 1996); STATE STATISTICAL BUREAU, CHINA STATISTICAL YEARBOOK OF 2000, 587 (Beijing: China Statistical Publishing House, 587).

87. IMF, *Balance of Payments: Statistical Yearbook*, 2 IMF BALANCE OF PAYMENTS STATISTICS NEWSLETTER 1, 64 (1999).

88. Nolan Cormac Sharkey, *China’s Tax Integrity in Context of the Emerging International Tax System*, 45 THE CHINESE ECON., 56-75 (2012); Dwight H. Perkins, *China’s Impact on the World Economy (Summary of main points)*, <http://www.jcer.or.jp/eng/pdf/DP1021e.pdf>; see also Kenneth Rapoza, *Just How Big is China’s Impact on the World Economy?*, FORBES (April 14, 2016) <https://www.forbes.com/sites/kenrapoza/2016/04/14/just-how-big-is-chinas-impact-on-the-world-economy/#479b5e7e7b9d>; see also Javier Silva-Ruete, *The Development of China’s Export Performance*, IMF (March 7, 2006) <http://www.imf.org/external/np/speeches/2006/030706.htm>.

89. *Id.*

foreign investments and international taxation questions, was created in the early 1980s. To facilitate economic reforms and foreign investments, China's first two tax laws were created: the Chinese-Foreign Equity Joint Venture Income (EJV) Tax Law⁹⁰ and the Foreign Enterprise Income Tax (FEIT) Law.⁹¹ The EJV Tax Law was applicable to "equity joint ventures formed by a foreign investor and a Chinese partner." Prior to these tax laws, the most common form of a partner was typically a state-owned enterprise. Alternatively, the FEIT Law affected various other forms of FDI; this included "different types of joint venture investments, joint explorations, and wholly foreign-owned enterprises." The EJV Tax Law offered a more substantial tax incentive compared to the FEIT Law because, during this time, China was still leery of foreign corporations doing business in their country without having a "local equity partner."⁹²

From the 1980s through the 1990s in China, there was a substantial amount of growth in special preferential tax regimes for FDI.⁹³ As its economy began growing and the world continued to evolve, China started to view itself as not only a major capital importer, but also a major capital exporter. In the last ten years, the Chinese government has initiated a new capital exporter policy. Under this new policy, there is an increased focus on investing abroad in order to capitalize on raw materials and have access to industrial assets, leading to a substantial increase in outbound FDI.⁹⁴

Although China arrived late to the tax treaty arena, it quickly closed

90. Li, *supra* note 85, at n.1 ("The Income Tax Law of the People's Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment (the "EJV Tax Law"), passed by the National People's Congress (NPC) on 10 September 1980. The implementing regulations for this law were issued by the Ministry of Finance on 14 December 1980. Individual Income Tax Law of the People's Republic of China was also promulgated by the NPC in 1980.")

91. Li, *supra* note 85 ("The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises, promulgated by the NPC on December 13, 1981 (the "FEIT Law"). Instead of the flat rate of 30% of national tax as under the EJV Tax Law, the FEIT Law imposed tax at progressive rates, ranging from 20% to 40%. A local tax was imposed at 10% of the national tax, resulting in the top rate of 44% (as opposed to 33% for equity joint ventures).")

92. Li, *supra* note 85, at 671.

93. *Id.* at 675; ALEX J. EASSON, TAXATION OF FOREIGN DIRECT INVESTMENT: AN INTRODUCTION 156 (Kluwer, 1968). "Although, more than half of the total foreign direct investment in China derives from Hong Kong, and approximately 80% of Hong Kong's outward investment goes to China . . . It is a common practice that foreign investors invest in China via their subsidiaries or branches in Hong Kong, partly because of the favorable tax environment in Hong Kong. Another explanation is that there is a substantial amount of "round tripping," i.e., domestic capital leaves China and re-invest from Hong Kong disguised as a foreign investment, in order to enjoy the benefits of Hong Kong's favorable tax incentives." *Id.*

94. John Chan, *China emerges as a major exporter of capital*, WORLD SOCIALIST WEB SITE (May 19, 2009), <https://www.wsws.org/en/articles/2009/05/chin-m19.html>.

the gap and has even overtaken other countries in its ability to shape optimal tax treaty policy and later implement it into Chinese domestic tax law. As of January 2012, China had ninety-seven income tax treaties in effect and had draft agreements with additional countries at various discussion stages,⁹⁵ creating a vast network of international treaties.⁹⁶

Since the globalization process and mobility factors have become significant in today's business landscape, the economies of China and the U.S. are strongly linked to one another. These two economies work closely together, but in some respects they are perfect opposites. For example, China is a net capital exporter in traditional manufacturing and a net capital importer in technology, services, and intellectual property,⁹⁷ while the United States is a net capital importer in traditional manufacturing and a net capital exporter in technology, services, and intellectual property. Due to this opposition, it is important to review and analyze the evolution that China has experienced over the last few decades and the resulting changes in its tax treaty policy.

B. *China's Tax Treaties Evolution and Basic Guidelines*

Although the modern income tax was not introduced in China until 1980, China was very quick to institute a negotiation program for tax treaties.⁹⁸ China began to negotiate tax treaties with other countries in 1983.⁹⁹ After ten years, it had over thirty tax treaties signed; after twenty years it had over eighty tax treaties signed; and as of May, 2015, China had more than ninety tax treaties signed.¹⁰⁰ Compared to other economies of this age, this output of treaties is an amazing feat, especially without a published tax treaty model.

However, China used its first tax treaty agreement with Japan as a model.¹⁰¹ Two definite guidelines exist under this basic Chinese tax treaty policy.¹⁰² First, the policy employs a differential approach when

95. *Tax Treaty*, STATE ADMINISTRATION OF TAXATION OF THE PEOPLE'S REPUBLIC OF CHINA (2015), <http://www.chinatax.gov.cn/2013/n2925/n2955/index.html>.

96. China is actively seeking to sign new tax treaties. For example, as of May 2010, it had signed ninety-one tax treaties. Hence, in about eighteen months, it signed six new tax treaties.

97. XIN ZHANG, *THE LAW & PRACTICE OF INTERNATIONAL TAX TREATIES IN CHINA* (Wildy, Simmons & Hill Publishing, 2003).

98. Alex Easson & Li Jinyan, *Taxation of Foreign Business and Investment in the People's Republic of China*, 7 NW. J. INT'L L. & BUS. 666, 677 (1986).

99. Japan was the first country China had a tax treaty with. See *Tax Treaty*, *supra* note 95.

100. *Id.*

101. Li Jinyan, *China's Tax Treaties and their Impact on Foreign Investment*, 10 TAX NOTES INT'L 1891 (1995).

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negotiating with different countries. If negotiating with a developed country, the Chinese government will be cautious about the counterparty's requirements for narrowing the taxation scope of the source country; if negotiating with a developing country, it will fully respect the counterparty's concern about the source taxation and require an equal treatment for both parties. Second, their process of negotiating a tax treaty identifies and represents the needs and concerns of both countries, understanding the importance of protecting the national fiscal interest and the needs for attracting foreign capital, technologies, and human sources. Although this second guideline seems very logical, this concept is not very common around the world, as it demands countries to put significant effort into understanding the ramifications of every tax treaty negotiation before the discussion has even begun.

C. *China's Tax Treaty Analysis*

Although China adopted a relatively new approach for a capital exporting country, China's tax treaty policy stayed the same, unlike other countries. Also, China's tax treaties are based on three different forms as opposed to one fixed form. For instance, if we examine Article 7, which deals with business profits in Chinese tax treaties, we find that the first version is almost a replication of the OECD Model, the second version is based on the U.N. Model, and the third version is an independent version. This approach may seem contradictory, as it is commonly said that the OECD Model favors developed economies, while the U.N. Model favors developing economies. However, a closer look will show that China is in a similar situation as the United States because in some parts of the world they are a net capital exporter and in others they are a net capital importer, and these models are geared towards characteristics of being a capital exporter or a capital importer country.

China will sometimes sign tax treaties under different models since it is better for its economic interests as a net capital importer. From the year 2000 until 2007, China entered into approximately an equal number of treaties that were based on the OECD Model as treaties that were based on the U.N. Model.¹⁰³ This analysis shows that, at that point, China did not have one tax model that it aspired to implement in each of its tax treaty negotiation processes, but conversely examined each

OF THE PRACTICE OF CHINA'S TAX TREATIES, 13-14 (The People's Publication Press, 1997).

103. Tianlong Lawrence Hu, *China Tax Treaty and Policy – Development and Updates* (August 11, 2013), <http://dx.doi.org/10.2139/ssrn.2642597>.

country and the economic relationship it had, or could have, with that country. Although not conclusive, there is no doubt this analysis was also influenced by the other party to the treaty, its different characteristics, the negotiating ability of each side, and many other factors that arise within meetings. China's economic power has only grown in the past few decades, so it is reasonable to assume that it has, at a minimum, some ability to favorably influence its position within treaty negotiations.

One of the major deviations between the OECD Model and patterns observed within China's tax treaties is Article 7.3, modeled after the U.N. Model. While they use the OECD Model text of Article 7.3 as the starting point, a few of these tax treaties contain parts of the U.N. Model or make additional limitations on the deductions allowed. This departure from the OECD Model is somewhat peculiar. If all factors were held constant, one would expect the tax treaties of any given country to be largely consistent regardless of the other party to the tax treaties. Yet, Article 7.3 of China's tax treaties varies from country to country.

Of the thirty-five tax treaties that China entered into with OECD Member countries,¹⁰⁴ thirteen of them use the U.N. Model Article 7.3 and twenty-two of them use OECD Model Article 7.3. Most of the tax treaties that used U.N. Model Article 7.3 were entered into in the 1980s, whereas those with the OECD Model were entered into from the 1990s and onwards. Generally, this signals that in China's earlier tax treaties it took the position of a developing country. This justified the use of U.N. Model Article 7.3, and China likely took this approach to limit the amount of deductions allowed to Permanent Establishments, thus minimizing the profit and tax being extracted from the country. However, as China moved into viewing itself as a more developed country and adopting the new capital exporting approach, the OECD Model Article 7.3 was accordingly used. Additionally, eleven of China's tax treaties use an Independent Article 7.3. See Appendix A for a much more detailed analysis.

In order to obtain a deeper understanding of China's tax treaties, a further look into the tax treaties that China has signed with Japan,¹⁰⁵ the United States,¹⁰⁶ and the United Kingdom¹⁰⁷ is necessary. The final tax

104. This number includes countries that were OECD Member countries at the time of the treaty negotiations.

105. China–Japan Treaty, *supra* note 76. The treaty was concluded on September 6, 1983, and became effective on January 1, 1985.

106. U.S.–China Treaty, *supra* note 74. The treaty was concluded on April 30, 1984, and became effective on January 1, 1987.

treaty this section will also focus on is the treaty between China and Hong Kong. Although this is not an income tax treaty, it can still be compared to the conventional tax treaty models (i.e., the OECD Model and the U.N. Model), and more importantly it will allow us to understand a lot more about Chinese international tax policy.

Each of the selected tax treaties is divided into traditional chapters and contains twenty-eight to thirty articles. However, there is one very clear exception to this: the China-Hong Kong tax treaty surprisingly includes only seven articles due to the fact that a number of specific provisions are embraced in the first three aforementioned treaties.¹⁰⁸ The most notable omitted provisions include income from immovable property, associated companies, or passive income such as dividends, royalties, interest, and capital gains.¹⁰⁹ With regard to personal taxation provisions, the China-Hong Kong treaty does not include pensions, government services, teachers, researchers, students, apprentices, or trainees.¹¹⁰ Furthermore, the China-Hong Kong tax treaty omitted other common provisions such as non-discrimination, mutual agreement procedure, and exchange of information.¹¹¹

A review of the residency question will demonstrate China's approach to tax treaties and the negotiation process, which will then translate to its tax policy. In most cases, under the Chinese residency laws, it is not possible for a corporation to be a "dual citizen" due to the strict definition of a Chinese Resident Enterprise.¹¹² However, if a corporation does have dual residency, the place of residency is determined under the China-U.K. Tax Treaty as the "place of effective management."¹¹³ If a corporation's management is in one nation and the head office is in another, then the relevant authorities of both nations

107. The Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, P.R.C.-U.K., July 26, 1984, (1984) [hereinafter China-U.K. Treaty]. The treaty was concluded on July 26, 1984, and became effective on April 1, 1985 (for corporation tax) and on April 6, 1985 (for income tax and capital gains tax) in the United Kingdom, and on January 1, 1985, in China.

108. Daniel K. Ho, *International Agreements for the Avoidance of Double Taxation: A Study of China*, 32 H.K.L.J. 677, 682 (2002).

109. *Id.*

110. *Id.*

111. *Id.*

112. See Coudert Brothers LLP, *China Tax and Customs Law Guide*, SINGAPORE: CCH ASIA PTE LIMITED (2001) ("It is simply not likely that an enterprise that was formed under [mainland] law, and is managed and controlled out of its head office in China, would also be considered to be a resident in another country.").

113. China-U.K. Treaty, *supra* note 107, at art. 4(3).

will work to reach a mutual agreement to determine the place of residency;¹¹⁴ the same will be done under the China–Hong Kong Double Taxation Agreement (DTA). On the other hand, in the China–Japan Tax Treaty, residency is not determined by the place of effective management, but instead where the “head or main office” is located.¹¹⁵ One of the main differences between the treaty signed with the United States and the treaty signed with Japan is the inclusion of the “Limitation of Benefits” provision.¹¹⁶ The main purpose of this provision is to attempt to reduce treaty shopping.¹¹⁷ The Limitation of Benefits provides that if a corporation is considered a U.S. resident under a treaty, if it can also be the resident of a third country that also has a tax treaty with China, then it will be considered a resident of only the said third country.¹¹⁸

Hence, as shown above, China accepted the counter party’s demands on the residency issue. From its own perspective, China even made a waiver allowing the other party to enforce its own domestic rules, which eventually should have enabled it to collect more taxes. However, in reality, China did not make significant waivers, if any at all, as it already dealt with the dual residency question in its own domestic law and made sure it would be unlikely to arise.

Another interesting way China’s tax treaty policy differs from others is how it utilizes the OECD and U.N. Models to shape its own domestic tax law. First, notions are presented in the tax treaties that

114. *Id.*

115. China–Japan Treaty, *supra* note 76, at art. 4(3).

116. U.S.–China Treaty, *supra* note 74. The “Limitation of Benefit” provision under the China–U.S. Tax Treaty “requires that a corporation or partnership have a greater connection with the parties to the treaty than simply being formed under a U.S. or a [mainland] statute. In order for an entity to benefit from the treaty, more than 50% of the beneficial interests in such an entity must be owned directly or indirectly by citizens or residents of the US or [China]. To benefit from the lower withholding tax rates provided in the treaty, more than 50% of the income subject to withholding must ultimately be beneficially owned by citizens of the U.S. or [China].” See Elizabeth Chippindale & Jefferson Vander Wolk, *Tax Treaties*, in HOWARD GENSLER, CHINA TAX AND ACCOUNTING MANUAL 316 (Hong Kong: Asia Law & Practice Publishing Ltd, 2nd ed. 1998).

117. The term “treaty shopping” refers to cases in which a person (which is usually a company) “shops around” or examines various tax treaties before they establish a holding company in the jurisdiction that provides the most favorable tax treaty treatment. See *Treaty Shopping & Anti-Treaty Shopping*, INTERNATIONAL TAX BLOG (May 18, 2008), http://intltax.typepad.com/intltax_blog/2008/05/treaty-shopping.html.

118. U.S.–China Treaty, *supra* note 74, at art. 4(4). An example is that a U.S. incorporated company can be considered a tax resident of the United States under the China-U.S. Tax Treaty. If the U.S. company has its head office in Japan, then according to the terms of the China-Japan Tax Treaty, the company can be considered a tax resident of Japan. In such situations, the China-Japan Tax Treaty prevails and the U.S. company is considered as a tax resident of Japan and not of the United States for treaty purposes; see Coudert Brothers LLP, *supra* note 112.

China signs, which are later integrated into domestic law. However, there are certain issues which can result from this practice. For example, in some instances, tax treaties have supplemented and clarified the domestic law, seen with the definition of “royalty.” This causes too much reliance on tax treaties and prevents domestic tax law from evolving.¹¹⁹

Tax treaties have had a significant influence over domestic law, which has made it more important for Chinese policy makers to understand, learn, and implement tax policies to the best of their abilities within each tax treaty that China negotiates. All in all, China serves as an example of a country that, in a relatively short period of time, synthesized a modern tax system and a substantial tax treaty network to serve the tax policy that aligns with its economic interests—meaning it implemented taxes on foreign investment in order to preserve an amount of the profit generated.¹²⁰

Applying the same analysis to the United States from a tax policy perspective, and assuming the U.S. Model serves as a benchmark for every U.S. tax treaty negotiation process, will conclude that this is hardly an ideal situation for the United States because of the unique position the United States has. Due to its unique position in the world, it is realistic to assume that the United States has a high probability of achieving a tax treaty as close as possible, if not identical, to its initial proposition during tax treaty negotiations. In this case, it is even more important that the United States configure and truly understand its optimal treaty structure since it has a much higher ability to achieve it than most other countries. If the United States were to adopt a more flexible and efficient tax treaty model, one that reflects economic transitions and the shift from a pure capital exporter to some type of a hybrid economy, the result of treaty negotiations would reflect the U.S.’s economic interests in a much more suitable way and eventually maximize its tax revenue. This would be true whether the model was a straightforward model or a more complex model that suggests different approaches to the various articles. In order to understand how the U.S. can create a more flexible structure in dealing with “developing countries,” it is important to analyze how Latin American countries have dealt with tax treaty issues.

119. THE IMPACT OF THE OECD AND UN MODEL CONVENTIONS ON BILATERAL TAX TREATIES: CHINA 261 (Michael Lang et al. eds., Cambridge University Press 2012).

120. Easson and Li, *supra* note 98, at 694.

VII. LATIN AMERICAN INTERNATIONAL TAX POLICY—WHAT CAN WE LEARN FROM IT?

A. *Latin American Countries—General Introduction*

As explained earlier, international organizations are reluctant to define the term “developing country” or “developed country.” However, in common practice, the OECD considers the following countries “developed”: Japan, Canada, the United States, Australia, New Zealand, Western Europe, the Southern African Customs Union, and Israel.¹²¹ All countries not listed above are thus likely considered by the OECD, U.N. and the WTO to be developing countries.¹²²

Another common way to define developing and developed countries is by using the Human Development Index created by the U.N. This analysis combines different measures including “life expectancy, educational attainment, and income (gross domestic product¹²³ per capita).”¹²⁴ According to this standard, a country is developed if it provides its citizens with greater education, health care, income, employment, et cetera.¹²⁵ Consistently, almost all countries deemed to be developed, using this standard, are the same countries listed by the OECD as such. This fact is hardly a surprise, since GDP explains “more than 50% of the inter-country variation in life satisfaction,” and it is a crucial factor in determining whether a particular country is developed or not.¹²⁶

Generally, a country’s GDP has three main elements: consumption,

121. GLOSSARY OF STATISTICAL TERMS, DEVELOPED, DEVELOPING COUNTRIES, OECD (2006) <http://stats.oecd.org/glossary/detail.asp?ID=6326>.

122. *See*, WHO ARE THE DEVELOPING COUNTRIES IN THE WTO?, WORLD TRADE ORGANIZATION (2015), http://www.wto.org/english/tratop_e/devel_e/d1who_e.htm. The WTO does, however, have a more specialized process to determine whether a country is developing because developing countries could receive benefits when negotiating a free trade treaty (e.g. longer exclusion periods for reduction of tariffs); *see also* General Agreement on Tariffs and Trade, 55 U.N.T.S. 187, Oct. 30, 1947, at art. XVIII.

123. Hereinafter, GDP.

124. JOHN HANCOCK, AN INVESTOR’S GUIDE TO ETHICAL & SOCIALLY RESPONSIBLE INVESTMENT FUNDS 286 (Kogan Page Publishers, 2005); U.N. DEV. PROGRAMME [UNDP], DEFINING AND MEASURING HUMAN DEVELOPMENT 9-10 (May 1, 1990), http://hdr.undp.org/en/media/hdr_1990_en_chap1.pdf.

125. U.N. DEV. PROGRAMME, *supra* note 124.

126. GDP is used to calculate the purchasing power parity per capita—one of the most recognized and objective measures of living standards used by the International Monetary Fund, The World Bank, and the Central Intelligence Agency. *See Economist, The Economist Intelligence Unit’s Quality-of-Life Index* (2005), http://www.economist.com/media/pdf/QUALITY_OF_LIFE.PDF.

investment, and government spending.¹²⁷ The interaction between these elements is not completely clear; however, it is possible that a greater investment rate generates a higher GDP. Therefore, to directly increase GDP, a country should increase its foreign direct investment.¹²⁸

According to a report on FDI in Latin America issued by the Economic Commission for Latin America and the Caribbean,¹²⁹ FDI increased thirteen percent from 2007 to 2008.¹³⁰ At that time, the average worldwide FDI decreased fifteen percent (related to the financial crisis).¹³¹ It is important to note that three countries—Brazil, Chile, and Colombia—received nearly eighty percent of that region's total FDI,¹³² because this shows us the vast difference between countries in Latin America and their level of development. Generally, in order for Latin American countries to become developed countries, they need to increase their GDP, which is subsequently linked to increasing their FDI. Such countries are, in essence, capital importers and typically, capital importer countries will choose to use the U.N. Model. This is a grossly oversimplified statement, but not necessarily untrue.

As with most developing countries, the majority of Latin American countries have relatively simple economic needs and depend upon the source-based taxes levied on foreign taxpayers.¹³³ In fact, many of these taxes imposed are not usually subject to source-based taxation in countries that are developed. This is to ensure maximum revenue generation. On top of that, most of these countries use a territorial tax-based system. Therefore, they receive no benefit from resident income earned outside of the respective country. Not only do they lose that potential tax revenue, but when it comes to the flow of revenue, it is mainly one-sided; foreign residents derive much more revenue from Latin American countries than residents from those countries derive from foreign sources. Therefore, for most Latin American countries, the current U.N. Model seems, on its face, to apply to their positions.

127. OLIVIER BLANCHARD, *MACROECONOMICS* 44 (Pearson Prentice Hall, 5th ed. 2009) (1997).

128. Hereinafter, FDI.

129. Hereinafter, ECLAC.

130. Econ. Comm'n for Latin Am. and the Caribbean [ECLAC], *La Inversión Extranjera Directa en América Latina y el Caribe* [Foreign Direct Investment in Latin America and the Caribbean] 7-149, ECLAC Doc. LC/G.2406-P, Sales No. S.09.II.G.24 (2009) (Sp.), <http://www.eclac.cl/publicaciones/xml/1/36091/LCG2406ef.pdf>.

131. *Id.*

132. FOREIGN DIRECT INVESTMENT IN LATIN AMERICA AND THE CARIBBEAN 2008, UNITED NATION 25 (United Nations Publications, 2009).

133. Matthew J. Kust, *Tax Treaties with under Industrialized Countries*, 13 *TAX EXECUTIVE* 175, 188-89 (1961).

The U.N. Model grants more significance than the OECD Model to taxation at the source rather than residency. Many countries in Latin America have signed tax treaties with both developed and developing countries and currently strive to sign more in the future. The main reason for this policy is to encourage the exchange of information and to promote FDI, which, as a result, promotes growth.¹³⁴ The U.N. Model is by far the model used most frequently when negotiating tax treaties in Latin America.¹³⁵ However, experience and experimentation have yet to prove the actual success of the U.N. Model in promoting growth.¹³⁶ Most developed countries are not eager to give up “tax authority for relevant businesses.”¹³⁷ This raises the question: do Latin American countries achieve their goal by signing tax treaties?

Assuming the goal is to create growth, the answer to that question is unfortunately not straightforward. Some studies show that the effect of tax treaties on FDI is minimal—less than ten percent.¹³⁸ Other studies, from sometimes even the same sources, show that tax treaties either have a neutral or a negative effect on FDI. Thus, it is impossible to determine whether one tax treaty model or another can even assist a country to achieve its goal and implement its tax policy efficiently. Moreover, it is crucial to understand that it is uncertain whether tax treaties actually foster a better international tax system compared to unilateral measures.¹³⁹

There are several countries in Latin America such as Bolivia, Costa Rica, El Salvador, Uruguay, Paraguay, and Panama, where foreign source income is not taxed at all,¹⁴⁰ that would not benefit from the

134. Nora Balzarotti, *Los Acuerdos de Doble Tributación y la Inversión Extranjera Directa: ¿Cómo se Relacionan?* [Double Tax Convention and Foreign Direct Investment: How Do They Interact?], 52 AMCHAM Technical Studies Series Document No.1 (2010); Hugo A. Hurtado, *Is Latin American Taxation Policy Appropriate for Promoting Foreign Direct Investment in the Region?*, 31 NW. J. INT'L L. & BUS. 313, 344 (2011).

135. This is of course, in theory only, since many countries in this region strive to sign tax treaties believing that this is a necessary thing to attract investment into their country, and as a result end up signing a tax treaty that is based on the OECD Model. For example, Chile signed a tax treaty with the U.S. that is much closer to the OECD Model than the U.N. Model because it believed it was a necessary step to promote economic growth in Chile due to the significant role the U.S. investment played in the Chilean Economy. See, Hugo A. Hurtado, *The U.S. and Chile Tax Treaty and Its Impact on Foreign Direct Investment*, 13 FLA. TAX REV. 41 (2012).

136. *Id.* at 139.

137. *Id.*

138. Bruce A. Blonigen & Ronald B. Davies, *The Effects of Bilateral Tax Treaties on US FDI Activity* 1-37 (Nat'l Bureau of Econ. Research, Working Paper No. 7929, 2000), <http://www.nber.org/papers/W7929.pdf>.

139. Hurtado, *supra* note 135 at 141.

140. John Prebble & David I. White, *Source and Residence: New Configuration of their*

implementation of the U.N. Model in terms of revenue because it may take a long time before these countries become net capital exporters and can actually use the benefit offered by the U.N. Model.¹⁴¹

Going back to two of the most basic assumptions in international tax, capital importing countries would aspire to maximize (1) the tax base and (2) the applicable tax rate. The result of these assumptions, as mentioned earlier, is that Latin American countries would prefer the U.N. Model for tax treaties. However, Colombia refrained from negotiating tax treaties until 2004 “under the philosophy of protecting the tax base,” when its government adopted an approach described by others as “attracting investment at any price.”¹⁴² When they began engaging in tax treaty negotiations, they went on to use the OECD Model. As a direct result, Colombia lost a significant amount of revenue because of the misconstrued belief that simply signing tax treaties with other countries would be beneficial for Colombia’s economic interests. This brings up another important factor in the tax treaty negotiation process: the outcome of such negotiations is quite likely to reflect the power balance between the two countries. The side that is better prepared and aware of all the possible policy issues affecting the negotiating parties will be able to gain a more beneficial result than the less prepared country.

Again, the most important issue concerning contemporary tax treaty models is whether a country can be classified as a capital exporter or importer, which requires a definition of the capital referenced. The models today are one-dimensional and unfortunately cannot provide an answer to the complex and sophisticated economies and tax systems that are adopted in many of today’s countries.¹⁴³ Therefore, when the adoption of a tax treaty model becomes necessary for a country, it must conduct a much more extensive and in-depth study of the goals it strives to achieve with each treaty partner before any further communication. Although researching the other side of the treaty is important, the results are sometime unpredictable. In some cases, a country that the OECD considers to be a developing country may prefer to use the OECD Model over the U.N. Model and vice versa. Also, it may be the case that a

Principles, 90 CAHIERS DE DROIT FISCAL INT’L 491 (2005).

141. Hurtado, *supra* note 135 at 141.

142. Martin Hearson, *Tax Treaty Negotiation: What Affects the Outcome For Developing Countries, Part I*, Martin Hearson: Tax, Development and International Relations (November 8, 2012), <https://martinhearsen.wordpress.com/2012/11/08/tax-treaty-negotiation-what-affects-the-outcome-for-developing-countries/>.

143. In many ways, tax treaties are like dinosaurs in the modern world of international trade.

country, whether it is a developed or developing country, does not care which model it uses, as the goals behind signing the specific tax treaty are not always economic, but rather political.

B. *The Federative Republic of Brazil*

1. Country Profile

Commonly referred to as simply Brazil, the Federative Republic of Brazil is the largest country in South America. It is also the fifth largest country in the world, both by geographical area and by population with over 192 million people. Brazil has one of the world's fastest growing economies, and is the largest national economy in Latin America. According to the World Bank, it is the seventh largest economy in the world, both by nominal GDP and purchasing power parity (as of the year 2014).¹⁴⁴

Between the years 1993 and 2017, 10,889 mergers and acquisitions transactions were announced with a total worth of \$1,143 trillion including the contribution of Brazilian firms.¹⁴⁵

Brazil's economy has gone through substantial changes over the past fifty years. In 1967, Brazil imposed almost sixty federal taxes, employed a territorial tax system, and did not impose corporate level taxation at all.¹⁴⁶ Such a tax system provided strong incentives to export, but at the same time, the lack of corporate taxation also inadvertently created an incentive for foreign investors to accumulate tax-deferred wealth in Brazilian corporate entities. This system is the exact opposite of a system that is created to establish capital export neutrality, like the United States, for example.¹⁴⁷ In contrast to the U.S. system, Brazil currently imposes only a few federal taxes, exercises a worldwide taxation jurisdiction, and taxes corporate income.¹⁴⁸ This alone

144. GDP Ranking, *Data*, THE WORLD BANK (2014), http://databank.worldbank.org/data/download/GDP_PPP.pdf and <http://databank.worldbank.org/data/download/GDP.pdf>.

145. Statistics on Mergers & Acquisitions, Institute for Mergers, Acquisitions, and Alliances, INSTITUTE FOR MERGERS, ACQUISITIONS & ALLIANCES, <https://imaa-institute.org/m-and-a-statistics-countries/#Mergers-Acquisitions-Brunei-Darussalam>.

146. Kathleen Matthews, *U.S. IFA Branch Explores Capital Flows to and from Argentina*, 7 TAX NOTES INT'L 1611, 1611 (1993); Albertina Fernandez, *Title of work*, 14 TAX NOTES INT'L 21, 22 (1997).

147. For a discussion of capital export neutrality, see generally, LABRENDA GARRETT-NELSON, *The Future of Deferral*, TAXING AMERICA 233-237 (Karen B. Brown and Mary Louise Fellows eds., 1996). The United States partially counterbalancing that incentive through the 1962 Foreign Controlled Corporations laws; see generally, I.R.C. §§ 951-964 (1997).

148. Matthews, *supra* note 146; *U.S. IFA Branch Explores Capital Flows to and from*

exemplifies the complete transformation, through extensive tax reform, that the Brazilian economy underwent. Brazil's tax policy must have changed as a result of the economic restructuring. It also shows that Brazil made a decision to adopt a tax policy that is more closely related to those of other developed countries. Therefore, Brazil's tax treaty network, signed prior to that reform, is no longer appropriate for Brazil's current economic goal and tax policy.

2. Brazil—Tax Treaty Policy

Although not considered by most definitions a developed country, in its tax treaty agreements, Brazil generally follows the OECD Model and its two methods to eliminate double taxation: (1) the tax credit method; and (2) the tax exemption method. However, some of the rules adopted in these tax treaties are similar to the provisions in the U.N. Model, which, in most cases, were drafted to be more beneficial to developing countries.

In 1967, in accordance with the postwar trend, Brazil signed its first tax treaty. Since that time, it has signed tax treaties with almost thirty countries.¹⁴⁹ The traditional doctrine regarding the relation between tax treaties and domestic law is in favor of the primacy of international law and is generally adopted by Brazilian writers. Notwithstanding this, treaties possess a hierarchical status equal to that of ordinary federal laws in Brazilian practice. Thus, conflict situations are settled by applying the *Lex Posterior Derogat Priori* principle. If the treaty is more recent than a conflicting domestic law, this law is overruled by the treaty.

Even though the United States is one of the most important world trade partners to Brazil, the two countries still do not have an active tax treaty,¹⁵⁰ mostly due to the “tax sparing” issue that was never resolved.¹⁵¹ As explained earlier, tax treaty provisions are often used merely as a tool to give legitimacy to, or perhaps rationale for, other non-economic reasons for failure to enter into a tax treaty. After fifty

Argentina, 7 TAX NOTES INT'L 1611, 1611 (1993); Albertina M. Fernandez, *Business, Tax Authorities Work Toward Consensus on Electronic Commerce*, 15 TAX NOTES INT'L 21, 22 (1997).

149. Brazil Tax Treaties, PRICEWATERHOUSECOOPERS, <http://taxsummaries.pwc.com/ID/Brazil-Individual-Foreign-tax-relief-and-tax-treaties> (stating that Brazil holds tax treaties with the following countries: Argentina, Austria, Belgium, Canada, Chile, China, Czech Republic, Denmark, Ecuador, Finland, France, The Netherlands, Hungary, India, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Norway, Peru, Philippines, Portugal, Slovakia, South Africa, Spin, Sweden, Ukraine.)

150. Yariv, *supra* note 56.

151. David R. Tillinghast, *U.S. Tax Treaty Issues*, 50 U. MIAMI L. REV. 455, 476 (1996).

years of political promotion between the U.S. and Brazil, an agreement has yet to be produced. At the same time, Japan¹⁵² and many EU countries have signed tax treaties with Brazil.¹⁵³ Therefore, the fact that Brazil has not entered a tax treaty with the biggest economic power in the world must be related, in one way or another, to more than just economic or tax reasons.¹⁵⁴

VIII. TAX TREATY MODELS—A SUGGESTED FUTURE

A. *The “Old” Tax Treaty Policy Way of Thinking*

As previously explained, the “old” mode of thinking when it comes to tax treaty policy is fairly straightforward and simple. The first step requires each country to identify itself as a developed country or a developing country. This step relies on the assumption that if a country considers itself to be a developed country, the right model for its economic use and interests is the OECD Model, while the U.N. Model serves the needs of a developing country. However, as previously explained, the definition of a developing or developed country is far from all-encompassing and can be easily manipulated for each country’s needs. Second, each model is too simple and single minded, meaning they were developed, written, and based upon a reality that is no longer relevant in many circumstances. Most likely, using these models “as-is” will not be ideal for most economies and countries. These irrelevancies could cause detrimental effects for countries that do not modify the original language of these models. As a result, when following the old pattern, almost all countries use either the OECD Model or the U.N. Model, or one modeled after these two. Perhaps the only country that does not follow this pattern is China, who instead tries to evaluate its economy’s current needs compared to the needs of each tax treaty partner prior to the negotiation process, which is expounded upon in the prior section.

B. *The “New” Tax Treaty Policy Way of Thinking*

Coupling the inherent difficulty in updating a tax treaty, due to the need to address every development, with the fact that tax treaties are never negotiated from scratch, a tax policy that fully comprehends and

152. Juliana Mello, *Brazil and International Tax Treaties*, THE BRAZIL BUSINESS, Sept. 10, 2012, <http://thebrazilbusiness.com/article/brazil-and-international-tax-treaties>.

153. *Id.*

154. See Yariv, *supra* note 56; S. Exec. Rep. No. 90-5 (1968).

embraces the guidelines necessary to accomplish a country's world trade goals is necessary. The tax policy also needs to be practicable, or in other words, realistically achievable.

This paper suggests a different approach to tax treaties, beginning long before the parties communicate. Each tax treaty must be negotiated separately in order to address the primary needs that are present in the two parties' economic relationship. First, each country should pinpoint the specific reasons for entering a tax treaty with the suggested partners. It should be noted that the suggested approach is that each country perform an in-depth study based on the parties involved, and not simply a general tax policy study. However, this paper does not suggest that such a general study is useless or holds no merit. Rather, such a general study should be used as a benchmark for a much more specific, ad-hoc, and up-to-date study prior to each tax treaty negotiation process. By utilizing this suggested process, the chance that the treaty negotiation team will have all the necessary information and tools to sign the optimal tax treaty would be enhanced each negotiation. The specific purpose for the treaty should be written in the document itself instead of simply opening with the recitation that "tax treaties are entered into between countries for the purposes of avoiding double taxation of international income flows and the prevention of fiscal evasion with respect to taxes on income and capital gains."¹⁵⁵ By adding the specific purpose to the opening statement, the negotiation team does not simply put words onto paper, but it can actually fabricate the specific tax treaty framework and significantly improve future interpretations.

Once the interested party's specific goals are identified, the second step is to design the optimal tax treaty to achieve those goals. One country that can effectively complete this step is China, since it is not confined by one specific tax treaty model, i.e., the OECD Model or the U.N Model, but has the freedom to adopt any aspect it wishes. This is based on the understanding that, although China generally has a customary international tax policy approach, it can still change, modify, and tweak any detail, case by case, depending on the other country with which it is negotiating. It is important to understand that this step may evolve from country to country, mainly because of each country's economic characteristics and interests. The more sophisticated and developed a country's economy, the more intricate this stage will be

155. Committee of Experts on International Tax Matters, Seventh Session, Basic Approaches to Tax Treaty Negotiation, UNITED NATIONS (2011), http://www.un.org/esa/ffd/tax/seventhsession/CRP11_Add3_BasicApproaches.pdf.

when trying to conduct the specific study for each potential treaty partner. Countries should not be afraid to step away from the standard treaty models and create a new treaty that incorporates unique details and specific issues that are most relevant to the countries negotiating the treaty. A country should acknowledge that it is not necessarily in its best interests to adopt one treaty model in hopes it will cater to its diverse set of needs, as it could potentially hinder future economic growth.

Once the first step is completed and finalized, the tax treaty negotiation team should have two things in its hands. First is the general tax policy study that describes the country's general tax policy and provides general guidelines, a high-level tax policy summary, and a macro perspective for their economic goals, aspirations, and policy. Second, they should have an up-to-date, specific, and detailed study that presents a comprehensive analysis of their country's economic relationship with the potential tax treaty partner as well as an analysis of their partner's economy, tax policy, and goals.

The specific study should address various factors related to the economic relationship between the two countries. For instance, the study should include a detailed analysis of the trading relationship between the two countries addressing the specific type of goods traded and the industries who cooperate and do business within the two countries, a comprehensive list of common interests, including incentives for the other country to enter into a tax treaty agreement with the first country, and a separate chapter discussing the other country's tax treaty network and specific characteristics in their tax treaty network.

Once the negotiating team has these two documents in its possession, it can draft an ideal tax treaty model for the negotiation process which will be used as a benchmark for its efforts. The created model does not have to be one of two—the OECD Model or the U.N. Model. In the case of very complicated economies such as the U.S. economy, the model can exhibit hybrid qualities by adopting different articles from the existing models and in some cases, even by including articles constructed by the team to fully represent their country's interests. This step would not be possible if the team was not able to obtain the information given to them in the prior step.

To better exemplify the necessity of this process, one should think about the United States' situation. Generally, the U.S. economy is neutral with respect to its capital export and import levels. However, in some relationships, such as those with countries in Asia, the U.S.'s main import is traditional goods, while it concurrently exports a majority of its intellectual property to these countries. These unique tax treaty situations

cause a significant amount of capital to be lost, mostly due to a failure to address these limitations and exceptions within the U.S.'s model.

In order to preserve the international tax framework that was built over the past fifty years, a number of certain procedures must be kept and respected. First, the general style and terminology of tax treaties must continue. For the most part, all contemporary tax treaties follow the same order of articles, terminology, and general language, whether employing the U.N., the OECD, or the U.S. Model as a benchmark for negotiations. This format should continue to be followed even if the suggested approach is adopted. It is extremely important that, no matter which model is used, or what changes are made during the negotiation process, the end result allow any person who reads the tax treaty to be familiar with the general structure, order, and language between the different articles. Any change within a model must be drafted according to the concepts mentioned above, thus allowing the model to be as effective and efficient as possible.

Second, the assertion that changes should be made within the models does not necessarily mean that these changes should be incorporated into all aspects of a country's policy. In this case, even significant alterations can affect a small number of articles while still utilizing the original language of the models. A quality-driven second study will make necessary changes more obvious and make clear which articles can be signed without any changes at all. As a result, the efficiency of the tax treaty doubles, both within the negotiation process and in the final treaty application.

An example of a specific, as well as significant, change is shown by the United States' situation: it is both a capital exporter and importer, most traditional manufacturing is done outside the United States and is imported into it, and a large amount of Intellectual Property is developed and exported to other countries. Under current tax treaties, no specific reference to this situation exists, mostly because few countries find themselves in it, for the model was developed before any country was in this situation. Hence, before even meeting for the first round of negotiations, the United States' primary goal should be to study this issue of designation and fully understand how it wishes to tackle it. Only then should the U.S. begin any treaty negotiations.

Depending on a number of factors—such as political pressure and needs, the economic needs of each country, and the level of comprehension and cooperation—the final goal in this process is to reduce the time required when negotiating a treaty. For instance, the U.S.–Slovenia tax treaty was signed after only seven months of

negotiations.¹⁵⁶ However, in complete contrast to that negotiation process, the United States and Brazil have been engaged in tax treaty negotiations since 1947, and it appears the parties are no closer to finalizing such a treaty than they were twenty years ago. Such a long, extenuating progression can never be successful, simply because it will not be able to meet a country's economic needs within a timely manner, no matter what those needs are. In addition to establishing an optimal result, the treaty negotiations process should start with an end game and be carefully administered to be as efficient as possible.

156. See Press Release, *Slovenia, United States to Begin Income Tax Treaty Negotiations*, UNITED STATES DEPARTMENT OF TREASURY (Oct. 23, 1998), <https://www.treasury.gov/press-center/press-releases/Pages/rr2771.aspx> (announcing the November 30, 1998 commencement of negotiations); Press Release, *U.S.-Slovenia Sign Income Tax Treaty*, UNITED STATES DEPARTMENT OF TREASURY (June 21, 1999), <https://www.treasury.gov/press-center/press-releases/Pages/rr3213.aspx> (announcing the June 21, 1999 signing.)

APPENDIX A

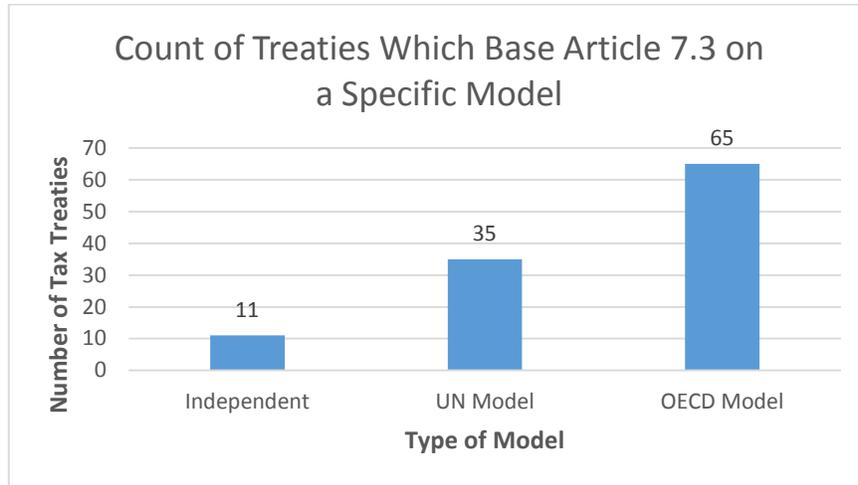


Figure 1

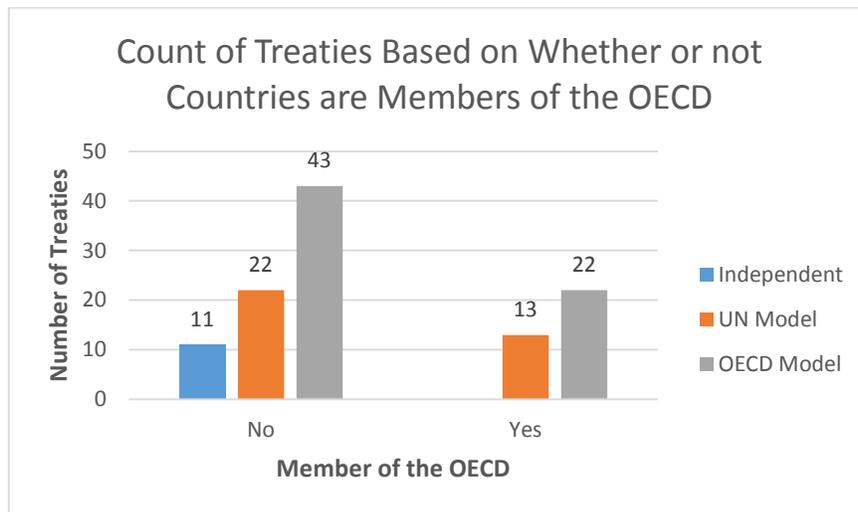


Figure 2

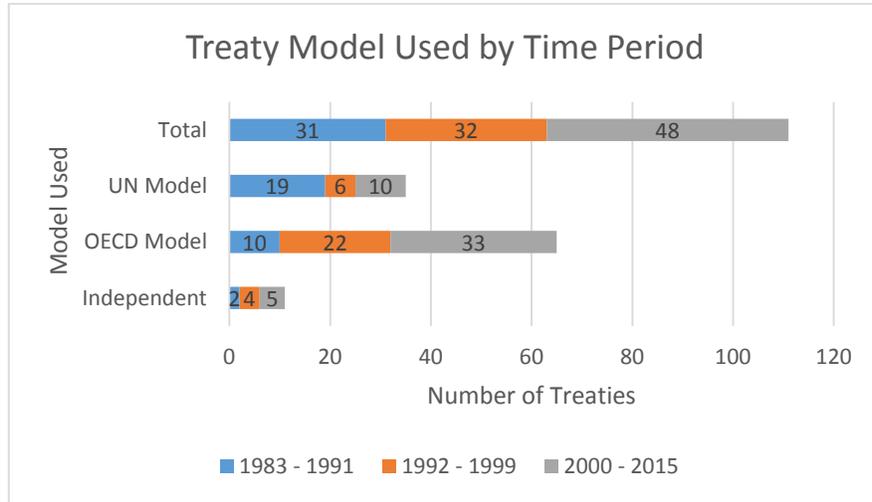


Figure 3