

Bilateral Income Tax Treaty Essentials

Tax treaties are bilateral agreements that serve to harmonize the tax systems of two countries and it applies not only to companies but also to individuals involved in cross-border investment and trade. In the absence of a tax treaty, income from cross-border transactions or investment would be subject to potential double taxation, first by the country where the income arises and again by the country of the recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income, between the two countries.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners. Treaties are the mechanism by which these taxes are lowered on a bilateral basis. If enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and non-creditable levels of foreign tax and to be at a competitive disadvantage relative to businesses from other countries that do have such benefits. Tax treaties serve to prevent this barrier to participation in international commerce.

Tax treaties also provide other features that are vital to the competitive position of global businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring tax laws to be applied in a nondiscriminatory manner to nonresident enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit that is available exclusively under tax treaties is the mutual agreement procedure, to resolve disputes in particular cases or reach bilateral agreement on issues of interpretation or application. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States and other governments by providing assistance for the administration of their tax laws and the implementation of their treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network. This article provides for governments to access information regarding certain flows of income from their residents to another country and enables countries to police their income tax laws.

As cross-border trade and investment expand, tax treaties are playing an increasingly important role in preventing the imposition of excessive or inappropriate taxes on global businesses and in ensuring the fairer and more efficient application of the tax laws. To continue to serve their intended purposes, treaties must keep pace with developments in today's global economy. The United States and some of its major trading partners have shown an increased willingness in recent years to reconsider such issues, as demonstrated, for example, by recent treaty agreements to eliminate withholding on certain cross-border dividends and to expand cross-border coordination with respect to pensions and stock options. The United States and many other member countries of the

Organisation for Economic Co-operation and Development (OECD) also have recently undertaken to evaluate and improve upon current treaty dispute resolution practices and mechanisms.

The handling of tax disputes between taxpayers and relevant governments is conducted by the Competent Authorities of their respective ministries or government departments.

The increasing magnitude and reach of cross-border trade and investment is prompting the negotiation of an ever-growing international network of tax treaties.

The general preference of US treaty policy has been to eliminate withholding taxes on interest, royalties or service fees. The historical preference for 5 percent rate of withholding on direct dividends has been abandoned in favor of a zero percent rate in several recent US treaties. To date the general approach for a zero rate on dividends has been to set the threshold to require the ownership of shares representing at least 80 percent of the voting power of the payor as provided in the recent treaties with the U.K. Australia, and Mexico and the Netherlands. The new treaty with Japan sets the threshold at more than 50 percent of the voting stock of the payor. The official United States treaty policy has, however, not yet been changed.

Generally, the US has chosen not to pursue a zero rate on dividend policy in the case of countries unwilling to agree to reciprocal zero rate provisions, and in the case of countries that are unwilling to address certain US treaty requirements, for example, inclusion of adequate limitations on benefits and exchange of information provisions.

The limitation of benefits clause operates to deny “treaty benefits” such as reduced withholding taxes to companies that are owned by residents of other countries. This is sometimes referred to as “treaty –shopping.” More than any other country, the US is focused on perceived treaty shopping problems. Treaty shopping can occur in the following two ways:

- 1) A taxpayer of a state that has no treaty with the US seeks the coverage of a favorable treaty
- 2) Or, a taxpayer of a US treaty partner, prefers the treaty of another country

So without certain restrictions on treaty shopping, a treaty with one country can become a treaty with the world.

The US also focuses on including exchange of information provisions in its treaties. This clause obligates a treaty partner country to provide information to the US and vice versa, for the purpose of enabling each treaty partner to enforce its tax laws. The partner that is asked for information is authorized to use its administrative information gathering powers, including compulsory legal process, to obtain any necessary information. Several types of information exchange can occur including names of payees, amounts of interest, dividends and royalties paid to residents of a treaty partner; simultaneous examinations of related tax-payers; spontaneous exchanges of information and exchanges of industry-wide information.