Comments on the Schedular Structure of Tax Treaties

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1. UNDERLYING BELIEFS AND ASSUMPTIONS

The underlying beliefs and assumptions regarding tax treaties are:

Tax treaties are intended to divide the jurisdiction to tax between the contracting states. Tax treaties are not intended to establish rules of taxation, which are a matter of domestic law.

Tax treaties are usually universal; that is, they cover the entirety of the tax base (although in some cases, when it proves impossible to reach agreement, one or more items may be covered by a "renvoi" to domestic law).

Tax treaties are optional for the taxpayer, who is entitled to reject them in favour of the rules of domestic law. The question of consistency in this regard ("picking and choosing" between a treaty and domestic law) is conceptually important, but jurisprudence is non-existent.

International tax arbitrage is, in the first instance, a product of domestic law; specifically, it flows from the different treatment given by different countries to the basic inputs of a tax system.

Tax treaties do not give rise to arbitrage; rather, they give rise to differences between the contracting states in the assignment of tax jurisdiction.

2. RUMINATIONS AND VIEWS

The author's ruminations and views are:

The debate on how to divide taxing jurisdiction for purposes of a tax treaty is potentially endless. Although a good theoretical argument can be made for inevitably favouring the country of residence, such an approach is obviously unacceptable to many countries, and some form of compromise on a case-by-case basis is required.

Compromises are messy. Looking for conceptual purity in result is bound to be fruitless.

Moreover, it is not clear why the outlines of any particular compromise – the identified elements of the tax base which are divided up – need to make sense. Apart from aesthetic considerations, it would appear that the only serious objection to a particular compromise would be if the contracting states failed to agree in substance (as opposed to form) on what they had done.

Agreement in substance on the detailed meaning of each element of the tax base seems just as elusive as avoiding arbitrage in domestic law. How, for example, can two contracting states hope to agree, with respect to interest, on a definition more specific than "compensation for money lent"?

Such a level of agreement will not prevent one country from viewing, for instance, a repurchase agreement as a secured financing, while the other country sees the agreement as a sale and buy-back.

It is better to develop a system for resolving such differences as and when they arise than to attempt to identify and talk through the countless potential differences in interpretation.

Candidates for such a system are "residence-country rules", "source-country rules", "exclude it from the treaty" and "leave it to the competent authorities". There are, of course, variations on these themes (arbitration), and there may be alternatives that make sense.

In the case of arbitrage with respect to "entity characterization", the choice has been made to apply the criterion of "residence-country rules". In the case of "residence" arbitrage, the approach with respect to individuals has been to "leave it to the competent authorities", and the approach with respect to entities has quite often been to "exclude it from the treaty".

Arbitrage with respect to items in the tax base – where does a particular transaction belong? – is presently left to the source country for purposes of applying its tax. It may be difficult to reverse this rule, and perhaps it should be made more general.

3. CONCLUDING QUESTIONS

The author's concluding questions are:

Is there a persuasive case for radical change in the way tax treaties are constructed?

Would it not be highly disruptive to discard 60-odd years of interpretative practice?

Do we too quickly reach the conclusion that the world has changed fundamentally by reason of (a) technology, (b) rising levels of sophistication in tax matters, or (c) inability or unwillingness of tax administrations to challenge questionable positions taken by politically powerful interests?