DOUBLE TAXATION AGREEMENTS VERSUS INTERNATIONAL TAX PLANNING

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Abstract

The issue of double taxation avoidance is immensely important for tax planning exercised by international holding companies. The present article presents the issue of cross-border related parties employing double taxation agreements for the purpose of devising their tax strategies. In particular, elaboration on double taxation avoidance through the use of countries bearing the characteristics of tax havens deserves attention. The nature of these countries allows for an optimal adoption of strictly defined constructions provided for in double taxation agreements. Analysis also covers the phenomenon of double taxation in the legal and economic sense. This perspective is significant for taxation of international holding companies as well.

Keywords: double taxation, agreements on the avoidance of double taxation, tax optimization, tax havens, holding

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Introduction

It must be clearly stated that the source of law on the taxation of profits of international holding companies primarily consists of European tax law and the provisions of agreements on the avoidance of double taxation. Some role, however small, is also played by the rules of national tax law regarding the avoidance of double taxation to the extent that tax conventions or European law are not applicable. The role of the influence exerted by European tax law on taxation of the category of profits in question has become more prominent as the economy has intensified and become more global. In conclusion, holding companies deciding to undertake foreign business activity must consider the legal regulations stipulated in international law (especially the provisions of agreements on the avoidance of double taxation and—to a very small extent—the provisions of national law regarding the avoidance of double taxation) as along with the regulations provided in European Union law.

The phenomenon of double taxation in international relations is a key issue in international tax law. To some extent, this type of holding-company activity goes beyond the tax-related territory of a company's state of residence. Because double taxation stands in direct opposition to the one-tax rule, it provokes reactions from countries struggling to eliminate the problem. Double taxation in international relations not only is caused by conflict between unlimited and limited tax obligations but also results from a conflict between the state of residence and the source state. Accordingly, the characteristic quality of double taxation is inevitability; although double taxation is effectively eliminated by national tax laws or bilateral agreements, it remains inseparable from holding companies' international business activity. This points to the conclusion that resorting to the use of a tax haven to reduce taxation is always (either directly or indirectly) related to the problem of potential double taxation. This link is clearly perceptible in the case of agreements on avoiding double taxation, which constitute the source of certain tax benefits. Holding companies strive to obtain treaty tax benefits through inclusion in the scope of entities to which bilateral agreements apply. The framework of actions undertaken by holding companies is adequately sophisticated to encompass even the transfer of income to tax havens.

The phenomenon of double taxation in international relationships may be discussed with reference to law and the economy. Economic double taxation occurs when the same income or capital is burdened with tax liability twice when it falls into the hands of different taxpayers. Therefore, entities are economically, but not legally, identical. Legal double taxation consists of taxing income or capital owned by a single person twice. On an international scale, double taxation is primarily caused by generating income both at home and abroad. It must be highlighted that the phenomenon of double taxation exerts a profound influence on economic processes (Endres, Schreiber, Dofmuller, 2006, 48). With respect to international law, double taxation is perceptible but has a less significant effect, which results, inter alia, in the lack of a direct prohibition of double taxation.

The primary objective of agreements on the avoidance of double taxation is to protect against legal double taxation by distributing the right to impose tax on income and capital (if taxed at all) between the states that are parties to an agreement. This effect is achieved by limiting the applicability of the contracting states' national law, not by altering it.

Other goals of these agreements include the following: protecting against economic double taxation, especially with respect to transfer pricing; protection against discrimination in of tax treatment; preventing tax avoidance by introducing special provisions that deprive some entities of certain treaty benefits, if required conditions are not present; countering tax avoidance or evasion through cooperation between tax authorities of the interested states; and stimulating investments in developing countries through the so-called tax-sparing credit.

Double taxation is considered undesirable for many reasons. However, the most important reason is that double taxation is simply unfair and constitutes a serious barrier to the international trade in which holding companies engage. Most countries include provisions to prevent double taxation in their national tax laws. Such regulations, however, do not instill confidence that another state will act according to the reciprocity principle. In effect, countries are forced to take action aimed at balancing their tax claims and thus to enter into bilateral agreements on the avoidance of double taxation.

In accordance with bilateral agreements and the provisions of both European law and national law in particular states, the avoidance of double taxation is achieved by adopting two methods: the exemption method and the tax-credit method. Another (third) method might also be identified, namely, offsetting. Furthermore, "tie-breaker" rules are applied to eliminate the double taxation that results from double residency.

There are no mandatory or generally applicable binding rules of international law concerning the taxation of cross-border profits generated by holding companies. Accordingly, the primary source of international tax law is agreements on the avoidance of double taxation. These tax treaties (conventions) are typical instruments that different between taxation of international profit and other types of profit. They also constitute "particular law" with the result that entities in the same legal and factual situation often experience many differences in their tax treatment. The fact that agreements on the avoidance of double taxation are based on the OECD Model Convention has a direct influence on how international tax law is applied, especially with respect to its relation to European law, which is completely different.

The mechanism of double taxation in the strategies of groups of companies

The issue of international tax law, taking into account especially double taxation agreements, is multifaceted and multilevel. This is particularly noticeable, if it is analysed from the perspective of holding companies conducting cross-border activity. The majority of international tax treaties are based on the Model Convention with Respect to Taxes on Income and on Capital[1]. Such bilateral agreements on the avoidance of double taxation form a fundamental or even the only constituent of the international system of tax law. The prevalence of agreements on the avoidance of double taxation is particularly significant in the case of taxpayer actions that are of a global or transnational character. Due to standardized international agreements, the tax authorities of particular states are offered the possibility of seeking bilateral cooperation.

Bilateral agreements on the avoidance of double taxation are not flawless legal instruments. Accordingly, it is necessary to perform a critical analysis of these conventions because it is only based on such an analysis that objective appraisal of this type of bilateral agreement is possible.

An ideal measure to avoid double taxation consists of legal regulations, with the

[1] OECD Committee on Fiscal Affairs.

result that the absence of an international agreement is not a problem (i.e., a burden) for the residents of a given country. However, if two countries enter into a tax treaty based on the OECD model, allowing only for minor alterations of its original content, then national law automatically becomes insignificant regardless of its scope. In this sense, bilateral agreements constitute an indispensable legal instrument in the majority of tax jurisdictions to eliminate the double taxation of incomes (Townsend, 2001, 225).

Agreements on the avoidance of double taxation are static and relatively ineffective, which creates numerous possibilities for engaging in international tax avoidance. These agreements constitute an "anomaly" in systems of law that consider the entire process of economic globalization, not only its bilateral aspects. The objective of a bilateral agreement is to solve possible tax problems only in connection with relationships cultivated by two countries and thus do not encompass all possible tax-related ties. Consequently, the effectiveness of such agreements is limited; in addition, they are mutually negotiated with respect to those relationships in the first place. In effect, each agreement must be treated as an institution *sui generis* in nature despite numerous similarities to other agreements with respect to its consequences. Such an approach leads to unfavorable after-effects because the structure of tax treaties no longer complies with the principle of fiscal balance in international relations. Each treaty is perceived from the perspective of a country's individual interests and consequently, from the perspective of economic entities with registered offices in the affected countries (Peralta, van Ypersele, 2006, 713). Thus, the concept of a bilateral agreement on the avoidance of double taxation has been distorted because it is often forgotten than the provisions of such agreements may also lead to significant tax consequences that influence the residents of other countries. Occasionally, even changes to national law create the need to revise bilateral agreements, but renegotiations are a complicated process that time-consuming and effective only over the medium term. Accordingly, changes that the OECD calls for often exist concurrently with old provisions of non-renegotiable conventions that are not suited to contemporary economic reality. Therefore, comprehensive reformation of all or at least the majority of tax treaties is practically impossible, which leads to the conclusion that such agreements are static. This also means that the distance between these conventions and the dynamically developing economy is becoming increasingly large and that in turn, the economy pressures tax authorities to introduce changes.

The international system of tax law is still based on the principle of a nation's autonomy in tax-related matters, and at the same time, international coordination with respect to this matter is severely limited. Notably, the current system favors certain entities over others (which is not a consequence of deliberate action by the EU Member States), especially international holding companies that minimize their tax liability by exploiting the low level of coordination among countries with respect to tax relationships. Moreover, the increase in the significance and number of international transactions makes these endeavors even more disturbing. A lack of cooperation between tax jurisdictions causes transactions to be subject to double taxation or, whether by accident or as a result of tax planning, such transactions enjoy tax privileges offered by countries engaged in tax competition. In this respect, tax treaties are the only and perhaps an insufficient platform for effective tax coordination. International holding companies exploit this situation, including the discrepancies among states' tax statutes and their agreements on the avoidance of double taxation. Consequently, cross-border business activity is frequently subject to a smaller tax burden than that imposed on business activity carried out in a single country (Peralta, van Ypersele, 2006, 714).

The prevalence of agreements on the avoidance of double taxation also causes another problem. This problem is manifested in, inter alia, the lock-in effect: in other words, agreements often may not be effectively altered due to their high number of countries-signatories. Under such circumstances, regardless of the deposited declarations, the OECD's policy is to supplement the Commentary to the OECD MC rather than to introduce inevitable changes. In addition, AADTs also produce consequences in national tax laws, but usually those consequences are limited to hindering the development of such laws.

Another issue connected to the agreements in question is the phenomenon of international tax competition. Some of the provisions of these agreements result in a reduced tax burden while encouraging developing countries to offer tax holidays or other preferential conditions to entities in an attempt to attract foreign investors. Nonetheless, most important is that the existing international tax system does not constitute an adequately strong basis for countries countering harmful tax competition to prevent international tax avoidance and evasion (Marchgraber, 2014, 295).

Furthermore, one ought to note another consequence of international tax treaties, namely, the so-called triangular cases that arise from these agreements. The manner in which international bilateral agreements are framed is intended to enable the avoidance of double taxation that might occur because of a relationship between two countries. However, occasionally more than two countries are interested in a tax situation. In such cases, bilateral agreements either are inapplicable or the practical side of the process is a source of serious complications. The most common example of the situation presented above is represented by the triangular cases, which usually result from the practices of international holding companies. Although bilateral agreements may partially solve the problem and in some cases, they are even adequate for this purpose, most agreements either do not contain any relevant regulations or those regulations are very limited. Moreover, if a tax base is divided among different tax jurisdictions, bilateral conventions are virtually useless (Sørensen, 2004, 1202).

One profoundly significant consequence that arises out of the applicability of AADTs is disregard for the rules of national tax law, which usually treats non-residents more restrictively than do international agreements. The conventions discussed here cannot form a complete system because concluding such agreements is very difficult for many states. It may not be overlooked that the negotiation and ratification of these agreements is time-consuming and costly and thus, small countries' resources are inadequate to comply with these requisites, especially if a country has other priorities. Considering the above-mentioned arguments, it must be concluded that it is only possible to grant the majority of developing countries full access to an extensive structure of AADTs at the multilateral level.

Tax conventions are marked by complexity primarily resulting from their large numbers, along with the fact that each individual agreement is a separate legal instrument. Accordingly, problems arise related to interpreting the particular provisions stipulated in the agreements. Similarity or identicality of the provisions of individual conventions do not guarantee that they will be interpreted in the same way in the same case by different states. Thus, we are witnessing a situation marked by legal uncertainty, which is only partially eased by the OECD Commentary to the OECD Model Convention because that Commentary does not address all of the tax issues that arise as a result of applying bilateral agreements. Discrepancies in interpretation may also arise from the differences between languages because the meaning of some terms or expressions may be different than those expressed in the language of the OECD MC. The sheer number of language versions enables a significant number of possible translations and may influence the meaning of particular terms, which have not always preserved the original meaning. The Commentary to the OECD Model Convention is often invoked in court decisions; however, its legal validity is at least questionable. Changes to the Commentary also apply to agreements whose validity commenced before these changes were introduced. This is extremely important because alterations to the OECD MC are binding only on agreements concluded later and agreements that are renegotiable (Xi, 2017, 17). In other words, the OECD attempts to solve problems by creatively interpreting the OECD Model Convention and usually avoids introducing fundamental changes to the Convention. One must remember, however, that the courts in Member States may disagree with the interpretation of the OECD Committee on Financial Markets, which does not have the same binding effect as that of an act of law (Gajewski, 2017, 171).

It is also noteworthy that the system of bilateral agreements is not—despite its many flaws—chaotic. In fact, together with European Union law and national regulations preventing tax avoidance, bilateral agreements enable limitation of the losses caused by the harmful minimization of taxation. It also eliminates almost all known forms of double taxation and ensures so-called informal tax coordination, which is manifested in tax bodies' awareness of actions taken by their foreign counterparts in adapting and adopting OCED solutions. It should also be highlighted that anti-haven regulations in some way supplement the international system of tax treaties in an attempt to make the system more coherent and effective.

It is difficult to conclusively judge whether bilateral agreements are the international tax system's perfect answer to globalization. In fact, it is possible to accept the view that taxes are not main factor disrupting the free movement of capital, and tax treaties are sufficient to eliminate the possible disruptions of that movement. However, it is questionable whether it is feasible for the free movement of capital to develop in a situation in which a tax treaty ceases to be a sufficient solution—i.e., if such a situation is achievable. That issue involves finding an alternative legal solution to bilateral agreements to avoid double taxing holding companies.

The existing framework of the system of AADTs limits multilateral cooperation. Furthermore, most countries are determined to prevent the problem of international tax avoidance on their own. This position is a result of several issues presented below.

The lack of multilateral solutions to prevent tax avoidance causes tax jurisdictions to be forced to rely almost solely on themselves. It is extremely difficult to undertake joint action aimed at on the one hand, reducing the number of holding company practices that consist of circumventing tax law and on the other hand, successfully taxing those companies' international transactions. This leads to paradoxical situations in which, for instance, tax jurisdictions do not impose tax on interest paid to nonresidents out of fear that such a tax would discourage investors from locating capital on their territory. Some countries do not tax income from certain foreign sources, claiming that a different tax policy might cause entrepreneurs to flee to other, more advantageous tax jurisdictions.

The development of international tax law depends on ensuring that each state employs a selected set of standardized tax-law institutions that will facilitate cooperation among them. To some extent, it is possible to achieve this aim without implementing a formal multilateral convention. Nonetheless, the establishment of a permanent international forum focused on a multilateral convention would contribute to strengthening the ties between states and would facilitate the development of appropriate solutions and help reach compromises in connection with many significant tax-related issues (Orlov, 2005, 38).

The stipulations of agreements on avoiding double taxation that are aimed at countering the phenomenon of tax circumvention are applied inconsistently. The current tax-treaty system considerably hinders the adoption of reforms that would regulate new issues as they emerge in practice, including taxing the income of controlled foreign companies (CFC), taxing capital gains made by nonresidents, thin capitalization, and others. In reality, none of these phenomena are consistent with the OECD MC. This results in two possible outcomes: either tax treaties' provisions are violated or national laws' provisions are disregarded (Marchgraber, 2014, 300).

A multilateral tax treaty might definitely facilitate the above-mentioned reformation of areas related to initiatives previously undertaken individually by particular countries. A multilateral convention may be systematically changed and adjusted to reality through appendices based on international consensus related to each change and adjustment. A multilateral convention may also constitute the basis for coordinated action in the international arena. However, joint action and the willingness of all countries with large capital markets are indispensable (Gajewski, 2017, 166). The implementation of a multilateral agreement does not mean that bilateral agreements will no longer be used; however, those agreements will be thoroughly reformed. It seems that the concept of a multilateral convention will institutionalize the process of international cooperation on taxation while serving as its formal manifestation.

Tax havens versus double taxation agreements

On the one had, mechanisms adopted in double taxation agreements and, on the other hand, national legislation of countries that are parties to these agreements will be of particular relevance for the issue under analysis. Thus, countries referred to as tax havens will serve a major role. Tax havens versus double taxation agreements._To appraise holding companies' cross-border policies, it is necessary to refer to bilateral tax treaties concluded by countries classified as tax havens because it must be noted that there is an observable link between the broadly defined phenomenon of using tax havens for the purpose of minimizing taxation and the applicability of AADTs.

Two categories of tax havens that are parties to AADTs may be identified:
- low-tax havens; and
- special tax havens.

Most low-tax havens enter into AADTs with countrie that impose high taxes. The choice of a tax haven with which a tax treaty is concluded leads to a situation in which a lower withholding tax may be imposed on income from sources located in states with high tax rates, provided an AADT stipulates that tax exemption is possible with progression.

Special tax havens are countries that generally impose high taxes but that have legislated special tax advantages or other conveniences for specific purposes. The most significant tax-related consequence of using a special tax haven is that a lower withholding tax may also be imposed on incomes from sources located in the state of an entrepreneur's (or investor's) residence. The same is true for low-tax havens (Ihori, Yang, 2009, 215).

Most European states have entered into AADTs with low-tax states; however, these conventions often contain a contract clause according to which the provisions of a given tax treaty are not applicable to companies that are residents of the second (contracting) country, where these companies are subject to low taxation(Endres, Schreiber, Dofmuller, 2006, 49).

The practice of entering into AADTs with tax havens must be appraised positively because it limits international tax avoidance and does not deprive either country's residents of the benefits of an AADT. This is because it is inadequate to make any *a* *priori* presumptions with respect to entities potentially interested in reducing their tax burdens. It must be noted, however, that no tax treaties have been concluded with states that are no-tax havens. This shows that in some way, AADTs are determinants of highly developed countries' tolerance for states that are actively engaged in tax competition.

The considerations delineated above demonstrate that applicability of agreements on avoiding double taxation to relationships with tax havens should be analyzed from two perspectives: the perspective of relationships between particular tax jurisdictions; and the perspective of taxpayers interested in avoiding either taxation or double taxation.

In the first situation, the general issue of a tax policy aimed at eliminating harmful tax practices should be considered. Here, a tax treaty may be treated as a form of a "privilege" accorded by countries imposing high taxes. In some circumstances, especially circumstances that are economic in nature, a need may also arise to regulate tax relations with another state, even if it is involved in harmful tax competition. The justified economic interests of a country's residents play a decisive role in this case. Moreover, the problem of double taxation is also of key importance because neither low-tax havens nor special tax havens completely waive the taxation of nonresidents (Ihori, Yang, 2009, 216). Although the tax isolation of tax havens seems to be the wrong solution, the assessment would force tax havens to reform their tax systems and adjust them accordingly. One may not lose sight of the fact that each time an agreement is concluded, there have been preceding negotiations, which are overwhelmingly influenced by the economically stronger state. It might, therefore, be legitimate to conclude that regulation the significant and simultaneously sensitive tax issues in bilateral agreements is a more effective legal solution than failing to implement regulations and acting only on the basis of national statutory law and OECD activity. It is obvious that AADTs cannot solve all of the law's problems related to international tax avoidance. They might even constitute a way to escape taxation that is manifested in the form of treaty shopping.

The applicability of AADTs concluded with states considered to be tax havens is also individual in nature. Whether a tax treaty has been concluded might constitute a decisive factor not only in making an investment decision but also in taxpayers' other actions. This is relevant both to tax avoidance and evasion and to the need to eliminate the double taxation of income earned by taxpayers whose priority is not tax minimization (Marchgraber, 2014, 299). The issue is relative in character, but it is certain that the legal measures against tax havens may not betray the principle of the free movement of capital, much less harm honest taxpayers. It would thus be reasonable to assess whether it is possible for taxpayers to use a tax treaty to reduce a tax burden and to determine the extent of the activity conducted by a state's own residents in the territory of a foreign country.

With respect to tax havens that have not entered into AADTs, an international holding company must be aware that it is obliged to declare its entire generated income both in the tax haven and in the state of residence. However, it is still a matter of discussion whether the practice of not concluding tax treaties with tax havens is caused by the low risk of double taxation or whether it is an attempt to prevent treaty shopping. In any event, to some extent such an approach counters tax avoidance that consists of using companies established in a tax haven for that very purpose. One should remember, however, that an investment made in a tax haven that has not entered into an agreement with a given country can eventually result in a less profitable undertaking due to two impositions of tax on the same income. For this reason, only two types of tax havens presented below, i.e., no-tax havens and no-tax-on-foreign-income havens, are noteworthy.

Interestingly, in principle, states that impose no income tax (i.e., the no-tax havens) do not enter into AADTs because “where one many not be taxed, much less may one be taxed doubly.” However, the consequence of the lack of a tax treaty is the impossibility of following procedures for the mutual communication and exchange of information (Peters, Snellaars, 2001, 45).

Conversely, tax havens referred to as no-tax-on-foreign-income havens do not impose tax on certain incomes from foreign sources. Such countries are characterized by their imposition of corporate income tax; however, they tax only income from domestic sources, not income generated abroad, which is exempt.

Conclusions

Undoubtedly, the issue that is being presented is multifaceted and needs to be examined from various perspectives and aspects. The phenomenon of avoiding double taxation is a key instrument adopted by international holding companies’ tax-optimization policies. The basis for this instrument is the application of the provisions of agreements on the avoidance of double taxation. The avoidance of multiple taxation of holding companies conducting cross-border activity has a crucial influence on the tax savings achieved. It is noteworthy that reducing tax by alleviating double taxation results in a considerable improvement in the entire holding company’s profitability.

If correctly applied, agreements on avoiding double taxation may also help international holding structures avoid tax. This effect is achieved by using tax havens. Obviously, in principle this phenomenon is considered as harmful tax competition.

It is clear that combining the possibilities offered by agreements on avoiding double taxation with tax havens may serve international holding companies’ tax-optimization goals. The use of an AADT is effective only if holding structures also use the national statutes of EU Member States that are profitable for such structure.

At the same time, one must remember that effective international optimization of taxation requires appropriate knowledge of the national tax regulations applicable in a given country so that savings achieved in one state will not be consumed by burdens arising out of a transaction with another state. Agreements on avoiding double taxation based on the Model Convention are one of the most important instruments for optimizing the taxation of holding companies, thus generating savings under international tax law. In addition to alleviating the phenomenon of the (legal and economic) avoidance of double taxation, application of an AADT also results in shaping the conditions for a transaction in such a way that income is subject to a lower tax rate, if the AADT stipulates two tax rates for that income. Therefore, AADTs are primarily concerned with differentiated tax rates. If a taxpayer's situation allows it to make a free choice, it is entitled to use the privileges contained in the tax treaties according to the principle *pacta sunt servanda*.

In summary, agreements on the avoidance of double taxation are usually bilateral in nature. Their primary objective is to solve the possible tax problems that arise solely in connection with relationships between two states and thus, they do not concern all potential tax relationships, which means that their effectiveness is highly limited. This limited character of bilateral agreements is significant from the perspective of international holding companies with undertakings that have registered offices in more than two states. In effect, this situation leads to a severe reduction in the importance of AADTs with respect to international holding companies' pursuit of tax-optimization policies.

When analyzing the possibilities for optimizing taxation of international holding companies, it is necessary to differentiate between two phenomena: avoidance of double taxation and tax avoidance. In principle, these phenomena lead to completely different consequences for holding companies' tax policies. It may be, however, that an action taken to avoid double taxation will lead to absolute tax avoidance on the part of a holding company. Therefore, the phenomenon of tax avoidance is indirectly related to the policy of avoiding double taxation.

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