Are Taxes Converging?

A Global Analysis of Tax Treaty Disputes
Edited by Eduardo Baistrocchi
Cambridge University Press (2017)
1,761 pages
Price: $375

Reviewed by Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, and Gianluca Mazzoni, SJD candidate, University of Michigan.

Eduardo Baistrocchi's outstanding new book on tax treaty disputes is the result of an intense five-year global collaborative project among international tax scholars, practitioners, and administrators. The book provides an unprecedented set of information and offers the first global qualitative and quantitative analysis of one of the most important international tax scholarship debates over the last decades: whether a binding international tax regime exists as a matter of customary international law.

Baistrocchi's book covers over 1,610 leading tax treaty cases and is grounded on both country-by-country and topic-by-topic analyses. In particular, it covers the so-called "pre-BEPS Reports Era" from 1923 — when four eminent economists reached the compromise underlying the tax treaty network — to October 2015, when the OECD and G-20 released the final BEPS package, "the most fundamental changes to international tax rules in almost a century,"[1] said OECD Secretary General Angel Gurría in an October 5, 2015, official press release.

Baistrocchi's book allows readers to make an informed decision about whether a binding international tax regime exists. The book demonstrates an increasing convergence between tax treaties and the OECD model. This finding is consistent with recent research by Elliott Ash and Omri Marian on comparing treaty language using natural language analysis.[2] Ash and Marian found that between 1970 and 2015 the similarity of the texts of over 3,000 tax treaties rose from 60 percent to 80 percent, primarily due to increasing influence of the OECD model treaty.[3]

These conclusions bolster the view that countries are not free to adopt any international tax rules they please, but rather operate within the current international tax regime context. For example, Brazil will likely have to abandon its long tradition of establishing fixed margins for gross profits and markups regarding the cost-plus method and the resale price method, and adopt rules modeled after the OECD guidelines (making use of comparable transactions) in order to join the OECD. Mexico and South Korea made similar changes upon joining the OECD.

Baistrocchi's book also has interesting implications for the ongoing debate on whether the "single-tax principle" is part of the international tax regime. Since 1997, the first author has argued that the core of the international tax regime is two norms, which he calls the benefits principle (active business income

[1] OECD, press release on final BEPS package (Oct. 5, 2015).

[2] Elliott Ash and Omri Marian, "The Making of International Tax Law: Empirical Evidence From Natural Language Processing," NTA Annual Meeting, Philadelphia (Nov. 9, 2017).

[3] The most similar article was article 9 (associated enterprise), and indeed that article and the arm's-length standard it has embodied since 1935 has the strongest claim to being customary international law, as shown recently by the behavior of the U.S. Treasury in the *Altera* case (*Altera Corp. v. Commissioner*, 145 T.C. 91 (2015)) (in which the government refused to admit that the cost sharing regulations depart from the arm's-length standard even though that would have helped its argument).

should be taxed primarily at source, while passive investment income primarily at residence) and the single-tax principle (income should be taxed once — that is, not more and not less than once).

This thesis has been controversial. While most commentators agree that the benefits principle has been the core of the international tax regime since 1923, several prominent international tax academics and practitioners in the United States and elsewhere deny the validity of the single-tax principle. Some doubt its coherence.[4]

In the book's introduction, Baistrocchi briefly describes a tax treaty dispute that seems inconsistent with the single tax principle. Instead of investing in India directly, foreign direct investors decided to route investments from the Netherlands to India through Mauritius to take advantage of the favorable India-Mauritius tax treaty. The use of a "shell company" incorporated in Mauritius, whose main purpose was investing funds in India, had two important implications. First, the transfer of shares of an Indian company controlled by a Mauritius resident company was not subject to capital gains tax in either country under both the India-Mauritius tax treaty and Mauritian domestic tax law. Second, it substantially increased Indian inbound foreign direct investment (FDI), which in the last decade amounted to $178 billion. Of this, $74.56 billion was routed through Mauritius, accounting for 42 percent of total FDI. Indian tax authorities were dissatisfied with this international tax planning strategy (also known as "offshore indirect transfer of shares') and tried to challenge it through the *Vodafone* case (*Vodafone International Holdings BV v. Union of India*, [2012] 341 ITR 1 (SC)). Ultimately, in January 2012 the Indian Supreme Court held that in the absence of any look-through provision in section 9(1)(i) of the Finance Act 2012, the transfer of shares of a foreign target company by a nonresident to a nonresident would not attract Indian tax even if the object is to acquire Indian assets.

Thus, under the Indian Supreme Court's interpretation, the gain from the sale of the shares would not be subject to tax at source or at residence, violating the single-tax principle. The Indian government found this result unacceptable. Through an ex post facto amendment to Finance Act 2012, the government inserted explanations 4 and 5 in section 9(1)(i). The retrospective amendment asserts India's source-based jurisdiction to charge capital gains tax on the indirect transfer of Indian assets, including the transaction in the *Vodafone* case. The legality of this retrospective amendment was subsequently submitted to arbitration by Vodafone under the India-Netherlands bilateral investment treaty. The outcome remains in doubt. But India clearly views double nontaxation as unacceptable in the context of indirect share transfers. China has taken a similar position.

Despite the existence of many such examples of double nontaxation, the tendency in recent years has been for most large countries to support the single-tax principle. For example, the 2016 U.S. model tax treaty explicitly endorses the principle. The official press release states that:

> The 2016 Model . . . includes a number of new provisions intended to more effectively implement the Treasury Department's longstanding policy that tax treaties should eliminate double taxation *without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance*. For example, the 2016 Model does *not reduce withholding taxes on payments of highly mobile income* — income that taxpayers can easily shift around the globe through deductible payments such as royalties and interest — *that are made to related persons that enjoy low or no taxation* with respect to that income under a preferential tax regime. [Emphasis added.]

[4]On this position, see, e.g., H. David Rosenbloom, "International Tax Arbitrage and the 'International Tax System,'" 53 *Tax L. Rev.* 137 (2000); Michael J. Graetz, "Taxing International Income — Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy," 54 *Tax Law Review* 261 (2001); Julie Roin, *Taxation Without Coordination* (2002); Mitchell A. Kane, "Strategy And Cooperation In National Responses to International Tax Arbitrage," 53 *Emory L.J.*89 (2012); and Adam H. Rosenzweig, "Harnessing the Costs of International Tax Arbitrage," 26 *Va. Tax Rev.* 555 (2007). For the contrary position, see, e.g., Reuven S. Avi-Yonah, "Commentary on Rosenbloom," 53 *Tax L. Rev.* 167 (2000); Yariv Brauner, "An International Tax Regime in Crystallization," 56 *Tax L. Rev.* 259 (2002); Fred B. Brown, "An Equity-Based, Multilateral Approach for Sourcing Income Among Nations," 11 *Fla. Tax Rev.* 565 (2011); Ehab Farah, "Mandatory Arbitration of International Tax Disputes: A Solution in Search of a Problem," 9 *Fla. Tax Rev.* 703 (2009); and Victor Thuronyi, "International Tax Cooperation and a Multilateral Treaty," 26 *Brooklyn J. Int'l L.* 1641 (2001).

Similar positions have been adopted by the EU in the anti-tax-avoidance package[5] and by the OECD in the context of BEPS. For example, the new preamble to the OECD model tax treaty states that:

> (State A) and (State B) . . . Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital *without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance*.[6] [Emphasis added.]

OECD Secretary General Gurría stated upon introducing the final BEPS package that:

> Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will *put an end to double non-taxation*, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective.[7] [Emphasis added.]

Baistrocchi's book shows how the international tax regime has evolved slowly toward coherence from its origins to 2015. The G-20/OECD BEPS efforts have now enshrined both principles of the regime in the tax treaty network. In particular, the new multilateral instrument, signed by over 70 jurisdictions (but not the United States), will incorporate the single-tax principle into over 1,000 tax treaties.[8] This, as Baistrocchi recognizes, represents a new era in international taxation. But to understand this new era, it is essential to appreciate what came before it, and for that Baistrocchi's book will be an indispensable guide. ■

[5] This includes the anti-tax-avoidance directive effective in all EU member states from January 2019. The directive directly implements the single-tax principle.

[6] Note that the language ("without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance") is identical to the U.S. language, indicating that despite not signing the new multilateral instrument the United States is aligned with the OECD on this issue.

[7] OECD, *supra* note 1.

[8] On the MLI, see Avi-Yonah and Xu, "A Global Treaty Override? The New OECD Multilateral Tax Instrument and Its Limits," *Mich. J. Int'l L.* (forthcoming, 2017).