

TAX TREATY OR TAX TRAITOR? DOES INTERNATIONAL TAX LAW  
REWARD CORPORATE MISBEHAVIOR?

**Imran Daniels**

Could international tax law limit the entitlement to tax treaty benefits through the consideration of ethics? Is this ethical element important for equitable cross-border trade?

These are not abstract questions. The purpose of international tax law aims to relieve double taxation that occurs when cross-border trade is subject to domestic tax rules in more than one jurisdiction. Without relief, double taxation would pose an uncompetitive burden that would prevent one state from doing business with another.

To facilitate cross-border trade, international tax treaties (“treaties”) are negotiated and signed between contracting states. International tax law is entered into force by tax treaties which are ratified into each state’s domestic law. As a result of the negotiation process as a binding sovereign agreement, treaties are said to be mutually beneficial. By entitling only one contracting state to taxing rights, treaties effectively block the domestic tax rules in one of the two contracted states.

In its normative application, treaties do this by determining the “resident state” and “source state”. This distinction is important in the relief mechanisms available to taxpayers – who are entitled to claim treaty benefits in their resident jurisdiction<sup>1</sup>.

For Multinational Corporations (“MNCs”), the reduction of income tax is an immediate increase in below-the-line earnings attributable to shareholders. On the other hand, states rely on tax collection in their state to provide essential services. In developing and often resource-rich countries, taxes compensate for the depletion of natural resources.

To increase profits, MNCs are often incentivized to reduce taxation at all costs. Through a mix of aggressive tax planning and the articles of treaties, MNCs may often shift taxable income from high corporate rate jurisdictions through to low in underhanded tax avoidance strategies – without ever breaking the law. In fact, treaty benefits can be sought from a source state without a treaty ever benefitting that state.

*The role of tax treaties to inflate global wealth –*

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<sup>1</sup> Domestic tax rules often predetermine the relief mechanisms available in its jurisdiction, through a combination of exemption, deduction or credits in lieu of foreign taxes, but ultimately this process prevents double taxation.

Consider two U.S. resident parent corporations who are subject to the statutory corporate rate of tax at 35% in their resident jurisdiction.

In 2013, Apple reported an effective tax rate of only 0.005% on its foreign income, a further reduction of 1% reported since 2003. In 2017, the U.S. multinational technology giant generated \$45 billion in foreign revenue yet paid foreign taxes at an effective tax rate of less than 4%.

Apple products, however, continue to be powered by a rare metal - cobalt - sourced by offshore mining corporations in the heart of the Democratic Republic of Congo (DRC) – whose soil holds half of the world’s reserves. These mining conditions have been likened to modern day “slavery”<sup>2</sup> where rape and other forms of sexual violence are used as strategic military tactics to destabilize resistance in mining communities. MNCs are often said to exploit this plague facing Congolese miners through negotiations that fuel low-tax offshore capital flight.

Apple is not alone. For its 2012 tax year, the American coffeehouse, Starbucks, reportedly paid foreign taxes of only 0.3% on foreign sales and made a profit of more than \$4 billion. The source of some of its free trade beans in Ethiopia, Uganda and Kenya is often riddled with controversy over farmer exploitation and cheap labor. In 2012, it arose that 30% of coffee plantation workers in Kenya were below the age of fifteen. Critics to the free trade coffee industries frequently report that in developing countries, the negotiated trade prices of offshore MNCs do not cover the farmers costs of production.

In both these examples, the source states ultimately lose more taxation from selling their resources abroad than is ultimately collected in their jurisdiction. Where states forgo more tax than is received, this inconsistency is known as base erosion.

Corporations are often able to reduce the corporate rate of taxation to a near-zero effective rate through the articles of tax treaties coupled with aggressive international tax planning. The link, however, between how the domestic tax law of one jurisdiction considers the right to protect and promote the interests of the other contracting states in international tax law remains silent.

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<sup>2</sup> Capital flight in the DRC historically exceeds GDP per capita and non-government organizations describe that one in seven children is dead before the age of five with nine per cent of its population in need of humanitarian assistance. This position has been referred to as “reminiscent of the colonial labor system if not of slavery”.

This silence can best be attributed to the ideals that international tax treaties are said to be, in principal, mutually beneficial sovereign tax agreements between contracting states. To this end, as a general rule, foreign trade of a resident corporation is subject to tax relief in that resident state no matter the broader consequence in the foreign source state.

In light of the above, could a question of ethics influence the entitlement to tax treaty benefits if the domestic rules of the state where the parent corporation is resident, denies this relief because of the broader social impacts this has in a source state? The outcome of tax treaties may otherwise perpetuate a critical issue of wealth inequality, shifting wealth towards developed countries through the resources of developing countries obtained without fair compensation.

*The real cost –*

Each year it is estimated that over \$1 trillion of developing countries' profit are diverted offshore facilitated somewhat through clever tax avoidance schemes by international corporations. This offshore flight has far deeper impacts in poorer African countries where it can reach up to 10% of net foreign trade or exceed GDP per capita.

Research suggests that Sub-Saharan Africa remains the most affected and vulnerable region in the world. In what is commonly referred to as the “resource curse”, developing African countries are often disadvantaged by their abundance of natural resources due in part to the unfair bargaining powers of large multinational corporations from developed countries. These corporations seek to extract resources at artificially low prices, which along with lax domestic tax laws in these states, results in resource mismanagement and capital flight.

MNCs often leverage from the lack of adequate anti-abusive domestic tax laws in a source state for cheap resource extraction, by shifting profits between subsidiaries placed in strategic global positions without fair compensation to the source state. In this way, the loopholes of international tax laws may unintentionally fuel base erosion and allow profits of multinationals to be diverted virtually tax-free to the resident parent company, if not otherwise prevented in the resident state.

*So, what can be done –*

Ethical considerations with reference to the purpose of treaties could be used to limit the interpretation of tax treaty relief. Where treaty relief would eliminate all forms of taxation or promote base erosion in a source state, treaty relief could be disallowed.

This ethical consideration may limit treaty relief in the resident state equal to its full statutory rate of taxation. This would penalize effective rates seen to be artificially unjust or base erosion relief requested from a source state.

An ethical anti-avoidance rule could preserve the purpose of tax treaties since the other contracting state, like the DRC, has not levied sufficiently its source-based juridical taxation equal to that of the resident parent corporation in the U.S.