TAX TREATY; CONCEPT AND APPLICATION

DESI ILONA
STPI Padang

ABSTRACT

Kata kunci; Tax Treaty dan tax system.

INTRODUCTION
Most of governments have attempted to reduce their corporate tax rates. It aims to attract foreign investor to invest or execute cross-border trade with this country. So, every country should run agreements among countries in order to increase of growth their countries. Many agreements can be executed by government in various sectors such as political, social, education, economic and so on. One of those agreements is tax treaty. The tax treaty help government to solve problem how much tax rate to burden among countries which execute their agreement. On the other hand tax treaty may promote international production and investment activities.

In other around, the government also encourages private sectors to export their goods or service in order to promote the higher export than import (positive international trade). Therefore, the company tries to develop their market through cross-border trade. There are many challenges, when the companies execute cross-border trade such many competitors, high costs, must do agreement before come to another country, different taxation in practice, and so on. In addition, the issue of the double taxation has been raising and brings to the tax treaty.

Tax treaty has been discussed among academic and practice's. They question that whether tax treaty has brought the issue of harmonization and fairness (fair for countries and tax payers). Therefore, the tax treaty has become hot topic in the subject of international taxations. Due to the significant impact of the tax treaty on country harmonization and tax payer fairness, the tax treaty topic is significant topic to be discussed.

This paper aims to explain the tax treaty in avoiding double taxation and building harmonization among countries in globalization market. This paper can be divided into four sections that are: first section begins with introduction; second part
would discuss about the concept of tax treaties which consist of factors has impact on tax treaty (such as globalization competitions, growth information technology, international trade, double taxation and so on), definition, type and procedure of tax treaty. Third part discusses the Malaysia-Singapore tax treaty which revised the old tax treaty based on the OECD model. And finally offer some recommendation and conclusion.

**Tax Treaty Concept**

This section would discuss about tax treaty concept. It would argue the factors affecting the tax treaty. It also argues about the definition, type and method of the tax treaty.

- **The factors have impact on tax treaty.**
  
  There are several factors which effect the tax agreements between two or more than two countries. The factors are:

  - **Globalization.**

    In global competitive era, the company can buy or sell goods and services and investor can execute investment in every country around the world. Furthermore, the company or individual have to do agreements with other company in another countries. In another hand, the company deals with the global market and has opportunities to increase profit. These opportunities have emerged new challenges and problems such as how taxation practices, financial reporting, and auditing among countries and how to make differentiation of product because of entangling two countries or more.

    This issue has also been discussed among academics. Adhikari, Tondkar, & Hora, (2002) state that due to increase in international trade and globalization of capital markets in the last two decades, both academics and practitioners have faced many new challenges and problems. Therefore, the globalization has a positive and negative impact on international trade and brings the issue of tax harmonization, such as tax treaty.

  - **Information Technology development**

    Information technology has been developed significantly. It makes everything become easy. For example, an electronic data interchange, electronic mail, electronic bulletin boards, electronic funds transfer and other network based internet technologies to manage the business or personal activity. In fact, the internet is creating a unique global marketplace that has the potential to change profoundly the way international business is conceptualized and configured (Srirojanan and Thirkell, 1999; Bennett, 1997; Kedia and and Harveston, 1999) in (Hughes & Glaister, 2001)

    However, (Paris, 2003) argue that the anticipated growth of new communications technologies, including the Internet and other digital networks, will make it increasingly difficult for states to tax global commerce effectively. In addition, the government has difficulties to collect effectively tax. Which country has the right to collect tax (resident and non resident)? And how much tax rate percentage is reliable and so on. In brief, information technology has an impact on the development of tax treaty.
• International Trade

Having discussed about many challenges which faced by the company that run international trade. One of challenges that are taxes practice (how rate tax, for who company pay tax, and soon). Furthermore, before the company does international trade, it has to see whether the particular country (host country) has tax treaty with home country. Brown & Manolakas, (2000) conclude that the success of such cross-border trade depends upon three factors: protection of intellectual property, access to foreign markets by service providers, and a minimized risk of double taxation. These factors are impacted by national laws, multinational conventions, and bilateral tax treaties.

Eden & Kudrie, (2005) argue that the international tax regime reduces transaction costs associated with international capital and trade flows, resolves conflicts between tax authorities and multinationals, and between home and host governments, and reduces the possibilities for opportunistic behavior by MNEs and by nation states. We can conclude that international has challenges. Therefore, the government attempts to reduce it through agreement, such as tax treaty.

• Double Taxation

Double taxation’s have harmful effects on the exchange of goods and services and movement of capital, technology and persons. So it is importance to avoid the obstacles of double taxation by developing economic relations among countries. the issue of double taxation had been raised post world war I (Paris, 2003). He state that the efforts to build a rudimentary international regime in the area of taxation gained momentum. And the possibility that different countries would attempt to tax the same cross-border transactions or income.

Eden & Kudrie, (2005) conclude that the goals of the international tax regime are to avoid double taxation of income and the prevention of tax avoidance and evasion. These goals are to be achieved through coordination and harmonization of national tax systems. So, the double taxation will be reduced through agreement as well as building harmonization among countries by establishing tax treaty.

• Taxation System

Every country has taxation system as guideline for related parties. It contends of taxpayer, tax rate, taxable income, and also there are many section for personal or company. Those things can help tax payer to report taxes as well as a guideline for tax authority office in doing their jobs.

In globalization market, every country executes trade between two or more than countries. Every country has different of taxation system. The problem arises about which tax system would be used by companies. Furthermore, OECD center tries to solve this problem regarding to tax policy and administration. It offers the model for OECD members and non member in order to do agreements. According to (Egger, Larch, Pflaummayr, & Winner, 2006), the OECD Model Tax Convention on income and capital (henceforth OECD Model) emphasizes two major objectives: the alleviation of double taxation and the restriction of tax avoidance. The treaty partners
are left free to agree on one or both objectives. In brief, due to different countries having various tax systems, the OECD model helps countries conduct agreements, such as tax treaties.

- **Definition of Tax Treaty**
  
  Dunlop (2006) define that tax treaty is to avoid tax barriers to cross-border transactions and investment through the coordination of potentially disparate tax systems. To facilitate this goal, a tax treaty seeks primarily to relieve double taxation by (1) assigning the primary taxing right to an item of income to one country and (2) requiring the other country to give up its right of taxation to that same item of income. Thus, one of the fundamental purposes of any tax treaty is "to eliminate double taxation more effectively than unilateral legislation such as foreign tax credit laws.

  Murphy, (2006) tax treaty law is to regulate cross-border relationships by allocating taxation rights between two contracting States. Degan, (2000) argues that tax treaties are primarily intended to redistribute tax revenue (from poor to rich countries), or to lower administrative costs (e.g., via the definition of tax terms between contracting countries). Daly, (1997) argue that tax treaties are designed to mitigate, if not eliminate, international double taxation of cross-border flows of income and capital.

  Tax treaty is used to relief of double taxation on globalizations market that is the legal utilization of the tax regime in order to deduct the amount of taxable base on tax rules which is agreed on two countries or more than two countries in across-border trade. In addition, tax treaty also builds harmonization among the participative countries. It also help to allocate the tax revenue from poor countries to prosper countries.

- **Type of Tax Treaty**
  
  - Based on number of countries involved in agreement

    The type of tax treaty based on number of countries involved in agreement can be divided into two types, which are bilateral and multilateral (Dunlop, 2006). Dunlop, (2006) argue that bilateral tax agreements are more common today than multilateral tax treaties because each nation's tax system is unique and complex; it is not practical to develop or attempt negotiation of general multilateral tax agreements along the lines of such international economic agreements as the General Agreement on Tariffs. (Dunlop, 2006) add that multilateral tax treaties address this issue by increasing tax uniformity amongst the larger number of contracting states and it, however, generally work best when applied to discrete or specific issues of taxation.

    Degan, (2000) argue that two primary goals of bilateral tax treaties are the elimination of double taxation of cross-border activities and the prevention of tax avoidance and evasion. According to (Daly, 1997), bilateral tax treaties attempt to strike a balance between the alleviation of international double taxation and the enforcement of single international taxation.

  - Based on type of taxpayers

    Tax treaty can be divided based on the contents of the agreement. Eden & Kudrle, (2005) argue that the types of taxes involved are also numerous; corporate and
personal income taxes, Withholding taxes, value added taxes, and mining taxes. Therefore, tax treaty could be in form of income tax (we call it as income tax treaty), value added tax (VAT Treaty), mining tax (mining tax treaty) and so on. On other word, the type of tax treaty in this perspective is more on the content of the tax treaty.

Tax treaty method

For simplicity, government in calculating tax in international trade, (Egger, Larch, Pfaff, & Winner, 2006) are giving method for international tax; that are credit method, exemption method, and deduction method. Under the credit method, foreign-sourced profits are taxed in both the parent and the host country, but the taxes paid abroad are deductible from the domestic tax liability. Under the exemption method, in contrast, domestic and foreign profits are taxed separately within their jurisdiction and finally method is the deduction method, which allows a deduction of foreign taxes from the domestic tax base.

Ida (2006) state that international double taxation treaties may then involve three possible provisions, or tax rules. First, governments can credit the tax paid in the foreign country, up to the amount that would have been incurred under purely domestic taxation. This credit method (CREF) leads to taxation at the higher of the two rates. Second, governments can allow the foreign tax to be deducted from income before the domestic corporate tax is applied. This is termed the deduction method (DED). Finally, foreign investment income can be completely exempted from domestic taxation, such that only the foreign tax is relevant. This is called the exemption method (EXE).

So government has to choose what tax rules will be adopted. The procedure of tax treaty may be begin with agreement among two countries or more than to run cross-border trade in order to avoid double taxation. After that, negotiate between tax authorities to deal of tax treaty content. Finally governments have to do memorandum of understanding (MoU) in tax treaty. Based on (Berman 2002) in(Dunlop, 2006) argue procedure, a tax treaty in the United States is negotiated by the Department of Treasury under authority delegated by the Department of State.

Eden & Kudrle, (2005) argue that the results of government cooperation in the international tax area include a variety of national tax policies, double tax treaties (DTTs), and model tax treaties and guidelines. National tax authorities commit themselves, through double tax treaties, to international equity and neutrality principles, expressed in terms of avoiding double taxation and preventing tax evasion and abuse.

AGREEMENTS

Nowadays, every country has cooperated with other countries bilaterally as well as multilaterally. The area of cooperation could be political, economic, education and so on. Furthermore, the government normally cooperates with other countries based on the formal agreement. The agreement is a tool used to achieve the deal between two countries and the agreement relate not just to the allocate efficiency of these two different types of taxation but also discuss administrative system which is used in order to reduce double taxation and as well as fairness.
Zester, (2006) argue that other tax treaty provisions that not only allocate taxation rights but which also constitute tax benefits are provisions that lead to an exemption, a deduction or a tax-free allowance. These rules do not eliminate double taxation, but rather reduce the tax levied in a singular Member State. According to (Daly, 1997), one of the main principles underlying the GATT (General Agreement on Tariffs and Trade) is that trade barriers, insofar as they are used at all, should involve tariffs rather than non-tariff barriers, so that negotiation could then concentrate on securing multilateral reductions in tariff rates.

According to (Matteotti, 2005) international agreements, like domestic statutes, require interpretation. However, there are many different approaches in interpreting legal texts within the legal systems of the various states. Some countries follow a strict literalism in interpreting tax statutes, some follow the canon that tax laws are to be interpreted against the fiscal authorities in case of doubt, and others take a liberal approach and permit non-literal interpretation to further the underlying policy of a tax statute.

The tax treaty consist of territorial, resident, person includes an individual, a company and any other body of persons that is treated as a person for tax purposes, international traffic, and so on. Furthermore, agreement should normally content of territorial, resident, person or company as taxpayers both of countries. The content of this agreement depend on that both of countries in order to minimize double tax.

Dagnese, (2006) suggest that the treaty has several provisions which provide tax benefit (Art 24 of the DTT) for investment in Brazil that is: residence, interest, dividends, licenses, and transfer pricing. (Dagnese, 2006) discusses in detail about the provision below:

- **Residence**
  Without the Treaty the state of residence of taxpayers is determined by domestic rules, which broadly allow incidents of double residency. For example, a German, living (and residing) in Brazil who keeps an apartment in Germany may be considered resident in both countries, and thus will be subject to taxation by both states on his worldwide income.

- **Interest**
  Earnings from capital investments received in Germany receive a matching credit at the rate of 20 per cent (Art. 24, para. 3(b) of the DTT), even though the Brazilian tax rate is limited to between 10 per cent and 15 per cent (Art. 11, para. 2 of the DTT). Interest paid on loans from German public banks are not taxed in Brazil (Art. 11, para. 3 of the DTT), as a way to stimulate the import of German equipment. As a result of the termination interest payments are going to be taxed in Brazil at the rate of 15 per cent, which may be credited in Germany at its actual value and no longer at 20 per cent.

- **Dividend**
  Even though the payment of dividends has not been taxed in Brazil since 1996, until 1995 the tax rate ranged between 10 per cent and 20 per cent (limited in the Treaty up to 25 per cent), nevertheless being credited in Germany at the rate of 20 per cent or 25 per cent (Art. 24, para. 3 of the DTT).
The limitation represented a warranty against a possible tax increase in Brazil, reducing the risk of investments. Nowadays dividends are not taxed in Germany (exception of 5 per cent, s. 8b, para. 5 of the KStG (German Corporate Tax Act), but it is not considered for the Treaty purpose) so that this Treaty benefit is not applicable.

- **License**

  The Treaty limits taxation of trademark royalties up to 25 per cent and of other royalties up to 15 per cent. Tax paid in Brazil could be credited in Germany at two possible rates: (i) 25 per cent, if the German resident who receives the amount has directly or indirectly 50 per cent of the voting capital of the Brazilian company; or (ii) 20 per cent for all other cases (Art. 14, para. 3(c) of the DT). 

  This matching credit mechanism may no longer be used after 1 January 2006. Furthermore no more protection through a limit of taxation on royalties will be available. Nevertheless, Brazil de facto overrode the 15 per cent limitation creating a 10 per cent contribution (CIDT), which may not be credited in Germany because it is not paid by the receiver of the royalty payment, but by its payer, causing a change of subject identity.

- **Transfer pricing**

  Brazilian transfer pricing rules do not follow the OECD standards and collide specifically with the concept of related parties and the use of arm's length values designed by the Treaty (Art. 7, para. 2; Art. 9; Art. 11, para. 7; Art. 12, para. 4 of the DT). Even though fiscal authorities are very reluctant to apply the Treaty and strongly prefer to benefit the Brazilian legal exigency of fixed unreal margins by some methods, administrative courts tend to consider the protection of the Treaty regarding the arm's length concept. The termination extinguishes any possibility of argumentation making reference to the Treaty.

Westcott, (2006) argue that, Switzerland has also concluded numerous income tax treaties to avoid double taxation, which usually provide for reduced with holding rates on dividends, interest and royalties.

For the purposes of this Agreement, the term resident means any person who, under the laws of that State, is taxed depend on his domicile, residence, place of incorporation or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. Without the treaty the state of residence of taxpayers is determined by domestic rules, which broadly allow incidents of double residency.

**Case study: The Malaysia-Singapore Tax Treaty**

Singapore and Malaysia are neighboring countries and members of the Association of South East Asian nation (ASEAN). Malaysia became independent in 1963 and Singapore in 1965. Malaysia and Singapore was signed a tax treaty at several times that are:
On August 16, 1966 first signed
On December 26, 1968
On October 3, 2004

The tax treaty Singapore-Malaysia consists of 19 articles that are (i) Personal scope article that a person who is resident in neither Singapore nor Malaysia would not be entitled to the treaty benefits. (2) Taxes covered article include the income tax, the tin profit, petroleum income tax and development tax. (3) General definitions article is the terms Singapore, person, and international traffic. (4) Omission of limitation of relief article is exemption or reduction of tax will be granted on income by the state of source only to the extent that the income has been remitted to or received in the other contracting state. (5) Resident article is a person who is resident in a contracting state for its tax purposes. (6) Permanent establishment article. (7) Business profits article (8) Shipping, air and road transport article. (9) Associated enterprises article. (10) Dividends article. From January 1, 2008 Malaysia and Singapore will use one-tier system in dividend tax (11) Interest article. (12) Royalties article. (13) Technical fees article. As used in the article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature. (14) Omission of capital gains article. (15) Article relating to income of individuals. (16) Income not expressly mentioned article. (17) Elimination of double taxation article. (18) Non-discrimination article. (19) Other articles.

The latest tax treaty aim to improve the scope of tax exemption and reduction based on the OECD model. Even though Singapore and Malaysia are not OECD members but it is using OECD model in new treaty. And this viewpoint also accords with the principle of good faith in treaty obligations. (Teck & Poh, 2007) discusses some key changes in the new treaties. The new treaty has extended the scope of tax exemption and reduction that is:
- The full exemption accorded to income from international transport and government income.
- The lower tax rates provided for interest and royalty incomes. For interest income maximum tax rate 10 percent and for royalty income in new treaty sets a maximum tax rate of eight percent.
- Under OECD Model, some administrative provisions are fairly on the new treaty
- The changes in the dividends article and maximum tax rate of five or ten percent for gross dividends
- The technical fee rate move down into 5% of gross amount.
- Resident article, Both Singapore and Malaysia adopt a management and control test for corporate tax residence

CONCLUSION

Most of governments have attempted to reduce their corporate tax rates which aim to attract foreign investor to invest. In other around, the government also encourages private sectors to export their goods or service in order to promote the
higher export than import (positive international trade). Therefore, the company tries
to develop their market through cross-border trade. In addition to both issue of the
double taxation and country competitiveness have been raising and brings to the tax
treaty agreement.

Many factors would affect the tax treaty, globalization, information
technology, international trade, doubles taxation and taxation system. Tax treaty is
used to relief of double taxation on globalizations market that is the legal utilization of
the tax regime in order to deduct the amount of taxable base on tax rules which is
agreed on two countries or more than two countries in across-border trade. In addition,
tax treaty also builds harmonization among the participative countries. it also help to
allocate the tax revenue from poor countries to prosper countries.

Tax treaty can be divided into several types; Bilateral and multilateral tax
treaty as well as based on the various taxes, such as income tax treaty, value added tax
treaty etc. and tax treaty has several calculating method; that are credit method,
exemption method, and deduction method. In addition, tax treaty content depends on
the country involved with the agreement. However, most of the agreement consists of
the territorial, resident, person who is liable to tax, dividend, interest, license, transfer
pricing etc.

Many countries have participated in tax treaty. The U.S. Canada treaty, for
instance, focuses on the avoidance of double taxation and the prevention of fiscal
evasion with respect to taxes on income and on capital.

The case of Malaysia and Singapore tax treaty, they have their tax treaty in
1966. And they had reformed their tax treaty third time. The latest reformation
occurred in 2006. In brief, the content of the latest tax treaty aim to extend the scope
of tax exemption and reduction. The detail important content is (1) the full exemption
accorded to income from international transport and government income, (2) the lower
tax rates provided for interest and royalty incomes. For interest income maximum tax
rate 10 percent and for royalty income in new treaty sets a maximum tax rate of eight
percent, (3) the changes in the dividends article and maximum tax rate of five or ten
percent for gross dividends, (4) the technical fee rate move down into 5 % of gross
amount, and (5) resident article, Both Singapore and Malaysia adopt a management
and control test for corporate tax residence.

We can conclude that the general objective of the tax treaty is not just to avoid
the double taxation, but also to build the harmonization and to allocate tax from the
poor country to the rich countries. Therefore, it would promote the fairness in the
world and to protect tax payer from paying higher tax payments.

REFERENCE

international accounting research in journal of international accounting
& taxation, 11, 39-49.

Brown, C., & Manolakas, C. (2000). Trade in technology within the free trade zone:
the impact of the WTO agreement, NAFTA, and tax treaties on the NAFTA


