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# Tax Treaty Shopping and Developing Countries: Serious Potential for Tax Revenue Losses

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**Summary of Working Paper 173**

*Analysis of the international network of double tax treaties reveals a large potential for tax avoidance. Developing countries are not, on average, more likely to suffer from tax revenue losses than other countries. Yet, this average masks that several countries, such as Bangladesh, Egypt, Kenya, Indonesia, Uganda and Zambia, are all vulnerable to substantial potential losses of withholding tax revenue by treaty shopping. The treaties responsible for this are referred to as potentially aggressive tax treaties.*

*This is concluded by two Dutch economists and tax scholars, in a study commissioned by ICTD.*

The international tax system is foremost based on the tax legislation of autonomous nations. The differences in tax legislation between these nations has always left room for tax planning by multinational enterprises (MNEs). These differences can be, and are, exploited to avoid taxation. The tax reductions by multinationals are the mirror image of tax revenue losses for national governments. Although tax planning may not be illegal, it may be considered undesirable.

In their attempts to attract foreign direct investment (FDI), national governments may offer opportunities to multinational enterprises to reduce their tax burden, possibly to the detriment of other countries. The Organisation for Economic Cooperation and Development (OECD) began to address harmful tax competition and harmful tax practices in 1998. Since then, the opportunities for tax avoidance only seem to have increased with the digitalization of the economy.

However, in the wake of the global financial crisis of 2008, budget concerns of national governments provided the impetus for international coordination. The G20/OECD Base Erosion and Profit Shifting (BEPS) initiative constitutes an ongoing agenda for combatting international tax avoidance. One of the actions on this agenda is combatting tax treaty abuse. When two countries conclude a bilateral tax treaty, they allocate taxing rights so as to prevent double taxation for enterprises engaging in cross-border economic activities. These double tax treaties often entail reciprocal tax reductions.

There are about three thousand of these treaties and this creates ample opportunity for tax avoidance in the international tax system. In particular, when third parties, not from the two treaty partners, get access to the treaty benefits, such as reduced withholding tax rates, this is often called 'treaty shopping'. The budget concerns of national governments, following the tax revenue losses by such practices, may be more pressing for developing countries. This paper focuses on the potential tax revenue losses from treaty shopping for a set of 18 low and middle-income countries by considering the tax system as an international network. Moreover, we identify the tax treaties which could be responsible for these revenue losses and refer to them as potentially aggressive tax treaties.

We calculate withholding tax revenue that would be collected by governments in a hypothetical scenario where MNEs structure their operations to make full use of treaty shopping opportunities that would minimize those withholding taxes. We then compare this with the withholding tax that would be collected if MNEs instead simply invested directly in their operating countries, without using any intermediate jurisdiction. Our analysis is performed using a network approach, applied separately to dividend, interest and royalty flows. From this analysis the most important potential conduit countries for all these flows are identified, and more specifically the first conduit country on the tax-minimising routes for income flows from each developing country.

The main findings are threefold. First, developing countries are, on average, less affected by treaty shopping in terms of potential tax revenue loss than other countries. This might be a surprising conclusion because the literature on international tax avoidance concludes differently. However, these studies do not focus on treaty shopping. The outcome follows from the fact that withholding taxes for dividends are already lower in developing countries, implying that the (relative) revenue losses from withholding taxes would also be lower in these countries. This is the case for all three types of income flow, but the effects are even more limited for royalties.

This average outcome, however, masks wide differences between countries, which suggests that one needs to look more in-depth. The second finding is that several countries, including Bangladesh, Egypt, Kenya, Indonesia, Uganda and Zambia, are vulnerable to substantial potential losses, up to 100 percent of withholding tax revenue, by treaty shopping.

Third, this vulnerability follows from very low or negligible tax rates in a small number of specific treaties. We refer to these treaties as 'potentially aggressive'. Two examples are the Uganda-Netherlands treaty and the treaty between Bangladesh and the United Arab Emirates. For most of the countries studied, there is one treaty that is the first stop in the tax-minimizing routes leaving the country, making it the largest source of treaty shopping risk. Many of these potentially aggressive treaties are with familiar conduit jurisdictions such as the Netherlands, Switzerland, the United Arab Emirates or Singapore. A policy suggestion is to renegotiate these treaties, with an eye to the other treaties that could also be used for treaty shopping, to avoid that these simply become the new channel for tax revenue loss.

These estimates of potential tax revenue losses are best seen as upper bounds, because of the limitations of our study. We focus on potential changes to withholding tax revenue, and do not consider changes to corporate income tax in the host country. We are not able to consider the possibility that reduced treaty rates may attract more foreign direct investment, and with it a larger tax base and higher revenues. We also ignore any anti-abuse and minimum tax rules.

Pillar 2 of the OECD's global tax reform proposal is expected to limit the 'race to the bottom' whereby lower income countries compete heavily for inbound FDI, offering investing MNEs tax cuts in many different ways, beyond reduced rates in treaties. If Pillar 2 successfully reduces tax competition, this may reduce the gains to businesses from treaty shopping.

**"Several countries [in the study], including Bangladesh, Egypt, Kenya, Indonesia, Uganda and Zambia, are vulnerable to substantial potential losses, up to 100 percent of withholding tax revenue, by treaty shopping."**

## Further reading

van 't Riet, M. and Lejour, A. (2023) *Tax Treaty Shopping and Developing Countries,* ICTD Working Paper 173, Brighton: Institute of Development Studies, DOI: 10.19088/ICTD.2023.049

## Credits

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