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Negotiating Bilateral Tax Treaties: Should Tax Treaties Involving Low-income Countries Contain a Sunset Clause?

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NEGOTIATING BILATERAL TAX TREATIES: SHOULD TAX TREATIES INVOLVING LOW-INCOME COUNTRIES CONTAIN A SUNSET CLAUSE?

Ogbu Okanga

Summary

This policy brief reflects on an underexplored proposition: that bilateral tax treaties – particularly treaties involving (middle- and) low-income countries – should contain an expiration or sunset clause. The brief examines some reasons why it may be sensible for a low-income country to make its bilateral tax treaty expirable, from its onset. It also highlights a few reasons why such a policy may not be advisable – or tenable. The brief concludes by exploring the design of a model sunset clause for inclusion in the UN Model Tax Convention.

Key words: bilateral tax treaties, sunset clauses, taxation

Double Taxation Treaties: Do Low-Income Countries (Still) Need Them?

Bilateral tax treaties (hereafter “BTTs”) are a vital tool of the international tax system and the global economy.¹ Their main objective is to facilitate international trade.² They drive this objective by relieving double taxation, coordinating/harmonizing domestic rules on cross-border taxation, systematizing efficient alternative (tax) dispute resolution, and facilitating inter-state

cooperation in the exchange of taxpayer information and the collection of taxes.³ Importantly, low-income countries also conclude BTTs – especially with high-income/capital exporting countries – to facilitate foreign capital – and technology – inflows.⁴ The basic justification for the conclusion of BTTs – as embodiments of favourable cross-border tax terms – is the promise that they stimulate foreign investment, and therefore, domestic growth.⁵

¹ Reuven Avi-Yonah, *International Taxation as International Law: An Analysis of the International Tax Regime* (Cambridge University Press, 2007).

² Richard L. Doernberg, "Overriding Tax Treaties: The U.S. Perspective" (1995) 9:1 *Emory Int'l L Rev* 71.

³ Diane Ring, "International Tax Relations: Theory and Implications" (2007) 60:2 *Tax L Rev* 83; Marius Eugen Radu, "International Double Taxation" (2012) 62 *Procedia – Social and Behavioral Sciences* 404; Ariane Pickering, "Why Negotiate Tax Treaties?", in

Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries (New York, UNDESA, 2014) 1.

⁴ Yariv Brauner, "An International Tax Regime in Crystallization" (2003) 56 *Tax L Rev* 259; Paul Baker, "An Analysis of Double Taxation Treaties and their Effect on Foreign Direct Investment" (2014) 21 *Int J Econ Bus* 341.

⁵ Karen B Brown, "Missing Africa: Should U.S. International Tax Rules Accommodate Investment in

However, the suitability of BTTs for low-income countries has long attracted scrutiny, on grounds of equity and efficiency.⁶ BTTs are generally based on the OECD Model Tax Convention, a framework originally designed for and, perhaps, better suited to the use of high-income countries.⁷ They can induce disproportionate revenue losses when not properly tailored to the peculiarities of low-income countries.⁸ The anticipated gains of BTTs for low-income countries can be elusive or, at best, dwarfed by the significant revenue losses that are attributable to their use.⁹

Despite these drawbacks, BTTs remain fashionable for most low-income countries. Low-income countries, apparently, remain largely committed to the idea of cooperative coexistence in a global economic order that is moderated/coordinated through BTTs and continue to believe in BTTs as a net benefits tool. There are at least two plausible

explanations for the continued rise in the number of BTTs involving low-income countries.¹⁰

A contracting state that considers itself bound to an unfavourable BTT may do any one of several things. It may overlook any misgivings and abide by the treaty. It may seek to renegotiate the treaty. It may (unilaterally) take steps to override or undermine the treaty. It may, ultimately, cancel or terminate the treaty.¹¹ We have seen these options play out, even for BTTs with low-income country partners. For instance, low-income countries seeking fairer treaty terms have embraced the UN Model Tax Convention as a blueprint for BTT

Developing Countries?" (2002) 23:1 U Pa J Intl Econ L 45; Allison D Christians, "Tax Treaties for Investment and Aid to Sub-Saharan Africa – A Case Study" (2005) 71:2 Brook L Rev 639; Eric Neumayer, "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" (2007) 43:8 The J Dev Stud 1501.

⁶ Alex J. Easson, *International Tax Reform and the Inter-Nation Allocation of Tax Revenue* (Wellington, NZ: Victoria University Press, 1991) at 20; Martin Hearson, Joy W Ndubai & Tovony Randriamanalina, "The Appropriateness of International Tax Norms to Developing Country Contexts" (2020) FACTI Background Paper 3.

⁷ Charles R Irish, "International Double Taxation Agreements and Income Taxation at Source" (1974) 23:2 Int'l & Comp L Qlty 292 at 294. See OECD, *Model Convention with Respect to Taxes on Income and on Capital* (Paris: OECD, 2017) (OECD Model).

⁸ Dagan, Tsilly, "The Tax Treaties Myth", (2000) 32:4 NYU J. Int'l L & Politics 939.

⁹ Yitzhak (Isaac) Hadari, "Tax Treaties and Their Role in the Financial Planning of the Multinational Enterprise" (1972) 20:1 Am J Comp L 111 at 125; Kimberly Brooks & Richard Krever, "The Troubling Role of Tax Treaties" in Geerten Michiels and Victor Thuronyi, eds, *Tax Design Issues Worldwide*, (The Netherlands: Kluwer Law International, 2015) 159; Petr Janský & Marek Šedivý, "Estimating the Revenue Cost of Tax Treaties in Developing Countries" (2018) 42:6 The World Econ 1828; Samuel Gebre, "Unfavourable Tax Treaties Cause Revenue Loss in African Nations", *Bloomberg Tax* (1 October 2020) online: <https://news.bloombergtax.com/daily-tax-report-international/unfavorable-tax-treaties-cause-revenue-loss-in-african-nations>.

¹⁰ See Martin Hearson, "Wen Do Developing Countries Negotiate Away their Corporate Tax Base?" (2018) 302 J Int'l Dev 233.

¹¹ See Frith Crandall, "Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping" (1988) 9:2 Nw J Int'l L & Bus 355.

negotiation and design.¹² Low-income countries have renegotiated BTTs¹³ and subscribed to the OECD's Multilateral Instrument (MLI) as a tool for addressing various inefficiencies bedeviling their existing BTTs.¹⁴ BTTs also, typically, contain a clause that outlines the termination rights of a contracting state.¹⁵ Rarely, some states have unilaterally exercised this right.¹⁶

One potential underexplored option for addressing BTT discontent is the inclusion of a sunset clause. Given that BTTs typically do not contain an expiration date, they subsist until they are explicitly terminated (or

invalidated).¹⁷ This is, arguably, good for certainty. However, considering the weight of skepticism that trails BTTs and their role in tax base erosion, it worth considering whether BTTs should be made expirable – and, perhaps, renewable following review – as is sometimes the case for some other forms of international agreements?

Sunset Clauses in International Law: A Glance

A sunset clause is a visible component of international agreements.¹⁸ A sunset clause is a provision that stipulates when a treaty is

¹² Scholars have observed that an increasing number of BTTs concluded by low-income countries are being tailored after the more favourable UN Model. See Patricia Brown, “How Hard Can This Be? The Dearth of U.S. Tax Treaties with Latin America” (2020) 74:2 *Uni Miami L Rev* 359, citing Wim Wijnen & Jan de Goede, “The UN Model in Practice 1997-2013” (2014) 68 *Bull Int'l Tax'n* 118. See also United Nations Department of Economic & Social Affairs, *Model Double Taxation Convention between Developed and Developing Countries*, ST/ESA/378 (September 2021) [UN Model].

¹³ National Treasury, Republic of South Africa, “Media Statement: New South Africa and Mauritius Tax Treaty Enters Into Force” (17 June 2015) online: http://www.treasury.gov.za/comm_media/press/2015/2015061701%20-%20Media%20Statement%20New%20South%20Africa-Mauritius%20DTA%20FT.pdf; Naomi Fowler, “India and the Renegotiation of its Double Tax Agreement with Mauritius: an Update”, *Tax Justice Network* 4 April 2019) online: <https://taxjustice.net/2019/04/04/india-and-the-renegotiation-of-its-double-taxation-avoidance-agreement-with-mauritius-an-update/>;

Will Fitzgibbon, “Lesotho Seals New Treaty with Mauritius, Hoping to Curb Tax Dodging”, *ICIJ* (22 July 2021) online: <https://www.icij.org/investigations/mauritius-leaks/lesotho-seals-new-treaty-with-mauritius-hoping-to-curb-tax-dodging/>; Nelly Chepkoech, Andrew Oduor & Alex Mathini, “Kenya: Status of the Kenya Netherlands Double Tax Treaty”, *Bowmans Law* (25 May 2022) online:

<https://www.bowmanslaw.com/insights/tax/kenya-status-of-the-kenya-netherlands-double-tax-treaty/>.

¹⁴ OECD, *Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (OECD: 28 July 2022) online: <https://www.oecd.org/tax/treaties/beps-ml-signatories-and-parties.pdf>.

¹⁵ See, generally, UN Model, Article 31.

¹⁶ Rex Africa, “The Bonfire of the Tax Treaties” (28 July 2020) online: <https://www.lexafrika.com/2020/07/the-bonfire-of-the-tax-treaties/>; Will Fitzgibbon, “Senegal Nixes ‘Unbalanced’ Tax Treaty with Mauritius”, *ICIJ* (26 May 2020) online: <https://www.icij.org/investigations/mauritius-leaks/senegal-nixes-unbalanced-tax-treaty-with-mauritius/>;

¹⁷ Invalidation occurs where a domestic court rules to set aside a BTT concluded by the state. This would typically occur on technical grounds, such as where the treaty was implemented without ratification. A rare such example is the decision of a Kenyan High Court to nullify the country's BTT with Mauritius, on constitutional grounds, based on an action brought by the civil society organization, Tax Justice Network Africa. Kennedy Senelwa, “Court nullifies Kenya's tax deal with Mauritius” *The East African* (2 April 2019) online: <https://www.theeastafrican.co.ke/tea/business/court-nullifies-kenya-s-tax-deal-with-mauritius-1415280>.

¹⁸ Sunset clauses can be found in domestic legislation too. For instance, the U.S. Patriot Act, enacted to deal

to expire.¹⁹ While not a ubiquitous treaty term, sunset clauses can be found in several prominent international agreements. For instance, the Treaty of Versailles, which ushered out the First World War, contained sunset clauses.²⁰ In the terrain of strategic offensive arms control, the New START Treaty between the United States and Russia contains an original 10-year sunset clause, and was renewed in 2021 (for 5 years) to avert expiration.²¹ The trilateral trade agreement between neighbours Canada, the United States, and Mexico, (CUSMA) contains a 16-year sunset clause.²² Sunset clauses are commonplace in bilateral investment treaties (BITs).²³

Sunset clauses leave in the hands of the contracting states the discretion to re-evaluate and determine whether to preserve or renew a treaty, based on subsisting factors and circumstances.²⁴ These examples evidence that sunset clauses are not a farfetched idea for international agreements,

including in economic-centric agreements, such as the CUSMA and BITs.

Should BTTs Involving Low-Income Countries Contain a Sunset Clause?

A few reasons why it may be apposite to include a sunset clause in a BTT, especially one involving a low-income country are discussed next. Also addressed are counterarguments to the inclusion of such a clause.

Systematization of Cost-Benefit Review

Countries conclude BTTs with certain expectations. For low-income countries – as earlier noted – expectations often include that a BTT would stimulate foreign capital investment and technology transfers. It is implicit that these gains would be trade-offs (compensation) for the tax revenue that is sacrificed through the BTT. Having an expiration clause in its BTT would provide a low-income country with systematic

with the events of September 11, 2001, contained a sunset clause for December 31, 2005.

¹⁹ See Antonios Kouroutakis, “Sunset Clauses in International Law and their Consequences for EU Law” (EU Parliament, Policy Department for Citizens’ Rights and Constitutional Affairs Directorate-General for Internal Policies: PE 703.592 - January 2022) at 10.

²⁰ See Treaty of Peace with Germany (Treaty of Versailles), signed at Versailles June 28, 1919, effective 10 January 1920, Article 280, Art 378.

²¹ U.S. Department of State, “New START Treaty”, online: <https://perma.cc/JA3K-YFG8>.

²² Protocol Replacing the North American Free Trade Agreement with the Agreement between Canada, the United States of America, and the United Mexican States, November 30, 2018, Article 34.7. It is worth highlighting that this trade agreement contains tax related provisions, which means that its eventual

expiration would, in a sense, be tantamount to the expiration of a tax treaty.

²³ Joachim Pohl, “Temporary Validity of International investment Agreements: A Large Sample Survey of Treaty Provisions” (2013) OECD Working Papers on International Investment, 2013/04.

²⁴ In 2015, Indonesia notified various treaty partners (including Hungary, France, Italy, and Singapore) of its decision to let its BITs with them expire, thereby allowing Indonesia to renegotiate the BITs that it was interested in reinstating. Rob Palmer, “BIT by BIT: Indonesia’s move away from Bilateral Investment Treaties continues”, *Ashurst* (1 July 2015) online: <https://www.ashurst.com/en/news-and-insights/legal-updates/bit-by-bit-indonesias-move-away-from-bilateral-investment-treaties-continues/>; Karen Mills, Rizki Karim & Daniel Pakpahan, “Overview of The New Indonesia-Singapore Bilateral Investment Treaty”, *KarimSyah Law Firm* (19 October 2021) online: <https://perma.cc/S9RC-E5VY>.

opportunities for stock taking. Since a BTT is only renewable if it serves its intended objective(s), the low-income country can readily take the opportunity of an impending expiration – and potential renewal – to evaluate the *actual* impact of the treaty both on investment and revenue. If a treaty is serving its intended purpose, then a contracting state would be inclined to renew it. Otherwise, the treaty can simply be allowed to expire without having to invoke the more hostile option of termination. Absent this entrenched review mandate, there is greater likelihood of an unfavourable BTT subsisting indefinitely, despite its low delivery of anticipated gains and detrimental impact on the tax base of the low-income country.

Refocus on Revenue Mobilization

Signing a BTT signals that a low-income country prioritizes non-tax benefits (e.g., foreign capital and technology inflows) over tax revenue at a given time. A sunset clause allows the state to be able to reprioritize domestic revenue mobilization at a predetermined future date, without having to cause an unnatural break in the lifespan of the embodying BTT.

Tax Treaty Overrides and Strategic Deviations

A tax treaty override occurs when a contracting state deliberately applies domestic legislation to accomplish specifically what a BTT forbids.²⁵ Beyond explicitly overriding a BTT, it is also possible for a contracting state to tactfully deviate from a BTT by implementing measures that undermine its intents and purposes.²⁶ It is not uncommon for states to unilaterally introduce new anti-abuse or denial of treaty benefits measures into domestic legislation or to apply tax rules in other ways that seem to undermine subsisting BTTs.²⁷ It is arguable that the spate of unilateral digital tax measures that have been introduced in recent years also reflect attempts by some states, dissatisfied with aspects of the subsisting BTT regime, to override or circumvent it.²⁸

Tax treaty overrides are widely viewed as a serious threat to the integrity of the BTT network.²⁹ Making BTTs expirable might be a useful approach to stemming the propensity for tax treaty overrides and other forms of BTT deviation. The period when a BTT is set to expire is also the ideal period to renew. This period would also present an ideal opportunity to explicitly accommodate or incorporate new or otherwise (potentially) contravening measures within the treaty.

²⁵ Doernberg *supra* note 2 at 74.

²⁶ *Ibid.*

²⁷ Omri Marian, "Unilateral Responses to Tax Treaty Abuse: A Functional Approach" (2016) 41:3 Brook J Int'l L 1157.

²⁸ See Katherine Karnosh, "The Application of International Tax Treaties to Digital Services" (2021) 21:2 Chic J Int'l L 513; KPMG, "Taxation of the Digitalized Economy: Direct Taxes", *KPMG Tax*

(February 5 2020), online: <https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf>.

²⁹ See, generally, Reuven S Avi-Yonah, "Tax Treaty Overrides: A Qualified Defence of U.S. Practice", in Guglielmo Maisto, ed, *Tax Treaties and Domestic Law* 65 (citing various scholars)

Absent such a window, states are more likely to unilaterally use tax treaty overrides or undermines it to work outside a BTT.

Reclamation of Tax Sovereignty

Taxation is an attribute of state sovereignty.³⁰ At one level, concluding a binding BTT may signal a surrender of fiscal sovereignty. At another level, a state's tax sovereignty may be further diluted by the potential avenues for tax abuse – base erosion and profit shifting (BEPS) – that a porous BTT enables.³¹ If a BTT turns out to be innately porous, but without an expiration date, then there is a potential for the BTT to constitute a perennial albatross to tax sovereignty (potentially without the affected state realizing it).

The only remedial options would be to either convince the treaty partner to renegotiate or to unilaterally terminate the treaty. Conversely, a BTT that is designed to expire preserves the residue of tax sovereignty that a state possesses. Its potential expiration provides contracting states with an opportunity to automatically reclaim their ceded tax sovereignty by simply not exercising the renewal option. The real prospect of expiration may also incentivise the otherwise unwilling treaty partner to renegotiate.

³⁰ Joseph H Beale, "Jurisdiction to Tax" (1919) 32:6 Harvard L Rev 587; A R Albrecht, "The Taxation of Aliens under International Law" (1952) 29 Brit YB Int'l L 145.

³¹ Okanga Okanga & Lyla Latif, "Effective Taxation in Africa: Confronting Systemic Vulnerability through Inclusive Global Tax Governance" (2021) AfJIEL 2: 100-121

Having made these arguments, the next sections deal with assessing why the insertion of a sunset clause in a BTT may not be ideal.

Potential for Uncertainty

The enshrinement of a sunset clause in a BTT could undermine the degree of certainty and comfort that a BTT ordinarily provides. Long term foreign investors that are partly motivated by tax cost considerations may be unsettled or deterred by the real prospect of a particular treaty benefit becoming unavailable during the pendency of their investment. To cushion this potential uncertainty, a sunset clause may be drafted to guarantee the favourable tax treatment to existing investors. It is also worth stressing that many tax incentives (tax holidays) – another important conduit of tax benefits – are designed to expire.³² Investors do not expect these benefits to be permanent – yet they invest. A BTT sunset clause should raise only as much discomfort as a sunset clause accompanying a tax incentive.

Ironically, perhaps, the likelihood of expiration that comes with a sunset clause (especially one with transitional provisions) may guarantee greater tax certainty for taxpayers than, say, the prospect of termination. With a sunset clause, taxpayers can have a clear idea of when a BTT's term will expire and can, thus, plan for that.

³² UNDESA & CIAT, *Design and Assessment of Tax Incentives in Developing Countries: Selected Issues and Country Experience* (New York: UN, 2018); World Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications* (Washington DC: World Bank, 2018).

Termination tends to be more abrupt, which can be rather disruptive for taxpayers.

Investment Short-Termism

Compared with an indefinite term BTT, a termed BTT could disincentivize long-term investment and render a low-income country attractive to only short-term investments. However, whether this becomes the case may depend on several factors, including the actual term of the BTT (or the amount of its unexpired term) and the availability of (adequate) transitional provisions.

The BTT Sunset Clause

A BTT sunset clause should clearly set out the expiration date and, if the contracting states so desire, set out conditions for renewal, including the empirical evaluation of its revenue and non-revenue implications. The clause may also include transitional provisions to address continuity issues regarding taxpayers whose economic interactions with the jurisdiction intersect the treaty.

Interaction with Termination Clause

It is important to stress that the presence of a sunset clause does not necessarily immunize a BTT from the prospect of termination. Termination can still occur under the terms of the BTT's termination clause or simply pursuant to a state's inherent sovereignty. However, while a state can pre-terminate a BTT before its expiration date, thereby, potentially,

unleashing consequences, the existence of a sunset clause (especially one that is soon to crystallize) may dissuade a state from abrupt termination. Where a sunset clause is non-existent, termination becomes a more appealing exit option.

Both the OECD and UN model BTTs contain a termination clause.³³ The two provisions have similar language, but this brief opts to set out the clause in the low-income country-tailored UN Model. Article 31 provides, in part, that:

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ____.

The inclusion of a sunset clause in a BTT would necessitate a corresponding amendment of the termination clause. To reconcile both provisions, Article 31 may be redrafted as follows:

This Convention shall remain in force for a period of..... years from the date on which it is ratified by the latter of the Contracting States (the Expiration Date). However, no later than 12 months before the Expiration Date either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination....

Importantly, even where there is no legal obligation to furnish reasons for terminating a BTT, exercising the termination option places, at least, a moral

³³ OECD Model, Article 31; UN Model, Article 31.

burden on a state to justify its decision. Otherwise, the actions of that state may be construed as arbitrary or highhanded, and such a state may be broadly perceived as unfaithful to its international commitments.³⁴

A sunset clause, on the other hand, reconfigures the nature of the burden, such that a state must show cause why a particular BTT should be retained or renewed. If the positive impact and continued usefulness of a BTT cannot be demonstrated, then there is no basis – nor moral obligation – to renew, and the treaty is allowed to expire naturally at the end of its extant term. This shift of emphasis is important in the context of stock taking, since it forces a state to seriously consider the stark ramifications of a subsisting BTT. Confronted with actual facts and figures – rather than prior estimates only – a low-income country would be better equipped to regiment its tax treaty policies.³⁵

Conclusion

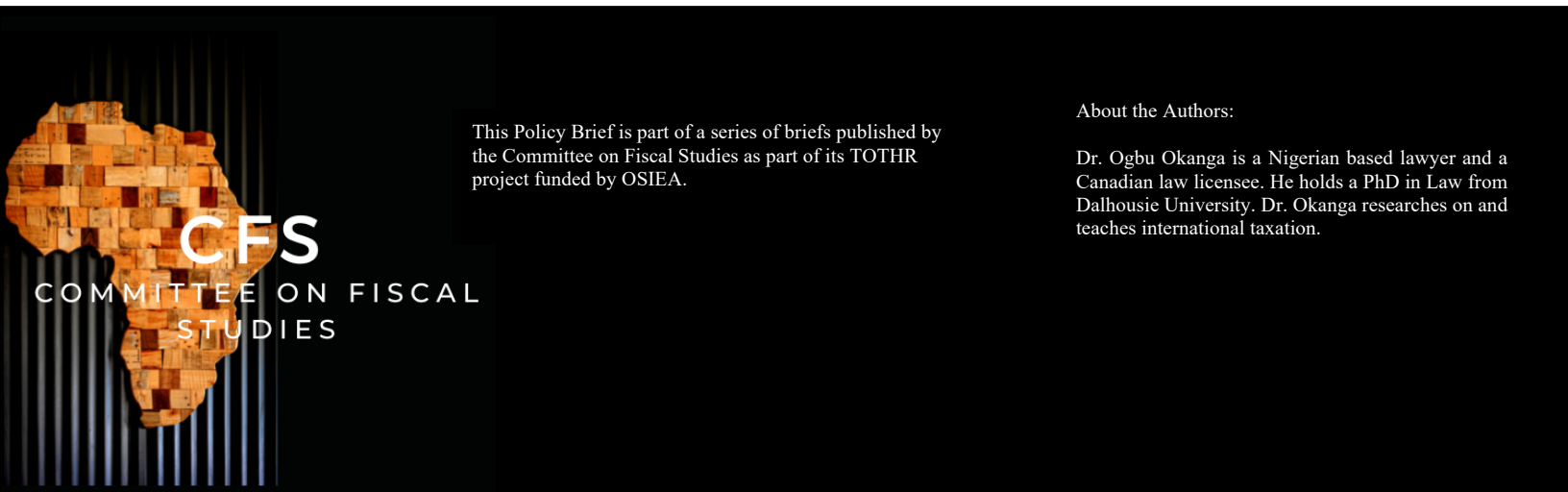
Policymakers should consider the use of sunset clauses in their tax treaties. BTTs are difficult to negotiate and are sometimes concluded at the initiation of low-income countries. Thus, letting BTTs expire might seem like a waste of endeavour. Yet, it has been articulated here, if the priority is to preserve the tax base integrity of low-income countries – that appears to be a cornerstone of the ongoing work on domestic revenue mobilization for sustainable development –

then this idea fits the bill and can be infused into concrete policymaking – and mainstream epistemic consciousness – through the UN Model Tax Convention. There is, of course, no reason why the OECD too cannot consider the idea for its model BTT.

Although this contribution does not advocate that a state should, ultimately, let its BTT expire – as that is a decision suitable for contextual analysis (based on specific facts and circumstances) – this brief proposes that a well drafted model sunset clause can be a valuable tool for a low-income country negotiating a BTT under circumstances of uncertainty as to the medium-to long-term fiscal and developmental ramifications of the treaty. Such clauses have been embraced in other aspects of international relations, e.g., nuclear non-proliferation, trade, and bilateral investment, and there are genuine reasons why they may just as well be sensible for international tax.

³⁴ See Crandall *supra* note11, noting how the U.S.’s abrupt and unilateral termination of its BTT with the Netherlands Antilles in 1987 not only disrupted the international bond market but could also undermine the U.S.’s credibility as a treaty partner.

³⁵ See Catherine Ngina Mutava “Review of Tax Treaty Practices and Policy Framework in Africa” (2019) ICTD Working Paper 102, discussing the dire tax treaty policy gap in many African countries.



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