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*The UK's tax treaties with developing countries during the 1970s*

Martin Hearson

## ABSTRACT

Tax treaties between developed and developing countries impose considerable costs on the latter, in the form of curbs on their right to tax investment from the former. Existing research assumes that such restrictions are accepted as a quid pro quo for resolving the problem of double taxation, which might act as an obstacle to inward investment. This paper uses archival documents to examine treaty negotiations between the United Kingdom (UK) and developing countries during the 1970s, focusing on contentious provisions concerning 'tax sparing', the taxation of shipping, and withholding taxes. Consistent with critical literature on tax treaties, it finds that neither side was concerned about the double taxation problem, which was resolved unilaterally by the UK's tax credit. Rather, developing countries were primarily focused on obtaining matching tax credits in the UK to maximise the benefits to investors from their tax incentives. UK priorities, meanwhile, were to bind developing countries into OECD-type tax treatment of British firms. Negotiated outcomes did not reflect the true balance of costs and benefits to each side, but their different negotiating capacities, the political salience of particular taxes, and the precedent certain concessions might set for future negotiations.

## INTRODUCTION

The United Kingdom (UK) has the widest network of bilateral tax treaties in the world. A large proportion of these treaties are with developing countries, especially former British colonies, most of which inherited colonial era agreements on independence, which they soon sought to renegotiate. The paper uses civil service documentation released under the UK's 30-year rule to analyse these treaty negotiations during the 1970s. Britain entered negotiations with about 40 developing countries during this time, successfully concluding agreements with just over half. Most of these agreements are still in force today.

Conventionally, tax treaties between developed and developing countries have been understood as tools through which developing countries sought to enhance their attractiveness to foreign investors, by eliminating the problem of double taxation and providing a guarantee against concerns about the instability of their tax systems. Developing countries, it is thought, accepted to have their taxing rights curtailed, as a quid pro quo for the investment-enhancing effects of tax treaties. Debate about the wisdom of developing countries concluding tax treaties turned, therefore, on the balance of these costs and benefits.

The evidence from the British negotiation files suggests that this view should be modified in a number of important ways. First, developing countries' negotiating experience and capacity were limited. Certain clauses within tax treaties were highly politicised, while others were little understood and attracted limited attention. This meant that the negotiating priorities of developing countries did not always correspond to the biggest revenue gains or losses. Second, 'tax sparing' clauses, which do not relate to the shared costs of double taxation relief, but rather to the effectiveness of tax incentives in developing countries, were often the main motives behind developing countries' pursuit of tax treaties. They also motivated the British, who actively sought tax treaties as tools to enhance the competitive position of their multinational investors in host markets, as well as to protect them from tax

measures that contravened OECD standards. Finally, negotiating priorities on both sides, but especially for Britain, were not dictated solely by the costs and benefits of the particular treaty concerned, but also by the precedent that they set for future negotiations, especially any precedent for deviation from OECD standards.

To illustrate these points, the chapter sets out various examples gleaned from the archived civil service documentations. It begins by setting this analysis in the context of existing literature on tax treaties and developing countries. It then moves on to some generalised discussion of British negotiators' priorities, before discussing three types of treaty provision that illustrate the priorities of developed and developing countries. These are 'tax sparing' provisions, the taxation of shipping, and withholding taxes.

## DEBATING TAX TREATIES AND DEVELOPING COUNTRIES

Tax treaties are bilateral agreements that divide up the right to tax cross-border economic activity, ostensibly with the aim of mitigating the risk that multinational taxpayers will face conflicting claims to taxation. The formal title of most tax treaties ('agreement for the relief of double taxation and [in more recent treaties] the prevention of fiscal evasion'), as well as the commonly used term 'double taxation treaties', reflects this understanding of their role. Indeed, the introduction to the OECD Model Tax Convention on Income and Capital ('the OECD model') states that:

The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons.<sup>1</sup>

The OECD model, on which work began in what was then the Organisation for European Economic Co-operation in 1956, is intended as a template for negotiations between developed countries. In 1968, with a growing number of treaties being negotiated between developed and developing countries, the United Nations established an ad hoc group of experts to consider the particular circumstances faced by such negotiations, leading eventually to the publication of a United Nations model tax treaty.<sup>2</sup> The principle difference between the OECD and UN model approaches is that the latter affords a greater share of the taxing rights within the treaty to the country of source, which is generally the developing country.<sup>3</sup>

Literature on tax treaties and developing countries has therefore tended to focus on the balance of costs and benefits to them, largely in the form of reduced tax revenue versus supposed increased inward investment. Several studies examining the withholding tax rates in groups of tax treaties have suggested that the UN approach, whereby more source-based provisions are included in treaties between countries with more unequal investment positions, is broadly consistent with negotiating practice.<sup>4</sup> In Honey Lynn Goldberg's words, 'treaty

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<sup>1</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD Publishing, 2014) 59.

<sup>2</sup> United Nations, *Model Double Taxation Convention between Developed and Developing Countries* (2011th edn, United Nations, 2011) vii.

<sup>3</sup> M Lennard, 'The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments' [2009] *Asia-Pacific Tax Bulletin* 4.

<sup>4</sup> HL Goldberg, 'Conventions for the Elimination of International Double Taxation: Toward a Developing Country Model' (1983) 15 *Law & Policy in International Business* 833; R Chisik and RB Davies, 'Asymmetric FDI and Tax-Treaty Bargaining: Theory and Evidence' (2004) 88 *Journal of Public Economics*

partners having unequal income flows will allocate jurisdiction to tax so as to achieve a more even balance between the two extremes.<sup>5</sup>

A critical literature sees matters differently. In her seminal paper *The Tax Treaties Myth*, Tsilly Dagan demonstrates through game theory that capital exporting countries will always have an incentive to relieve double taxation unilaterally in the absence of a treaty.<sup>6</sup> It is certainly the case that most capital exporting countries, including the UK during the 1970s, already give outward investors a unilateral credit or exempt their foreign income from tax altogether. Critics argue that, by concluding tax treaties, capital-importing developing countries have therefore been subsidising capital-exporting countries' international tax systems. One particularly powerful example of this school of thought was written by Charles Irish, a legal adviser to the Zambian government, in 1974. He argued that:

The practical effect of the present network of double taxation agreements between developed and developing countries is to shift substantial amounts of income tax revenues to which developing countries have a strong legitimate and equitable claim from their treasuries to those of developed countries. Concomitantly, these double taxation agreements result in a very considerable and unnecessary loss of badly needed foreign exchange reserves for developing countries. In other words, the present system of tax agreements creates the anomaly of aid in reverse - from poor to rich countries.<sup>7</sup>

In the 40 years since Irish's publication, numerous other scholars have questioned the wisdom of the tax treaties concluded by developing countries.<sup>8</sup> The focus of much of this criticism is not necessarily the existence of such treaties *per se*, but the terms of tax treaties that developing countries have signed. Surveys of the tax treaty networks of developing countries have tended to suggest that some developing countries have not been as successful as others at retaining their taxing rights, for reasons other than simply the amount of revenue at stake.<sup>9</sup>

Tax history scholarship can help to contextualise this discussion by opening a window onto the objectives and strategies of tax treaty negotiators. Rather than assuming *a priori* that

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1119; T Rixen and P Schwarz, 'Bargaining over the Avoidance of Double Taxation: Evidence from German Tax Treaties' (2009) 65 *FinanzArchiv: Public Finance Analysis* 442.

<sup>5</sup> Goldberg, above n 4, 907.

<sup>6</sup> T Dagan, 'The Tax Treaties Myth' (2000) 32 *New York University Journal of International Law and Politics* 939. See also E Baistrocchi, 'The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications' (2008) 28 *British Tax Review* 352, arguing that, while Dagan's result holds for an individual pair of countries, once several developing countries are competing for inward investment, they face a prisoner's dilemma and the conclusion of a tax treaty is in effect a defection.

<sup>7</sup> CR Irish, 'International Double Taxation Agreements and Income Taxation At Source' (1974) 23 *International and Comparative Law Quarterly* 292, 292.

<sup>8</sup> V Thuronyi, 'Tax Treaties and Developing Countries' in M Lang and others (eds), *Tax treaties: building bridges between law and economics* (IBFD 2010); see also RS Avi-Yonah, 'Double Tax Treaties: An Introduction' in KP Sauvart and LE Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press, 2009); K Brooks and R Krever, 'The Troubling Role of Tax Treaties' in GMM Michielse and V Thuronyi (eds), *Tax Design Issues Worldwide*, vol 51 (Kluwer Law International, 2015).

<sup>9</sup> V Dauer and R Krever, 'Choosing between the UN and OECD Tax Policy Models: An African Case Study' (2012) (European University Institute, Robert Schuman Centre for Advanced Studies, EUI working paper RSCAS 2012/60); M Hearson, 'Measuring Tax Treaty Negotiation Outcomes: The ActionAid Tax Treaties Dataset' (University of Sussex, Institute of Development Studies, International Centre for Tax and Development Working Paper No 47, 2016); W Wijnen and J de Goede, *The UN Model in Practice 1997-2013* (International Bureau of Fiscal Documentation, 2013).

each side's objective from a given tax treaty was to maximise its taxing rights, detailed studies of negotiations can reveal the more complex, dynamic nature of negotiating positions. Maikel Evers' study of early Netherlands-Germany negotiations, for example, shows how one treaty emerged as a personal project of two tax diplomats with their own distinctive views of their countries' national interests.<sup>10</sup> Contributions to a volume examining country negotiating histories highlight that capacity constraints limit developing countries' ability to prepare for and participate effectively in negotiations: Uganda 'has a weak tax treaty negotiation team that concludes treaties more intensively reflecting the position of the other contracting state,' while in Colombia in the 2000s a policy of 'attracting investment at any price' led to poorly-prepared negotiations and an outcome that was less favourable to Colombia than might otherwise have been the case.<sup>11</sup> One suggestion often made in discussions of this topic is that some tax treaties may have been concluded by developing countries for political reasons, with little consideration for their content at all.<sup>12</sup>

Inspired by these examples, the next sections use civil service documentations obtained from the British National archives to help understand the determinants of some of Britain's early tax treaties with developing countries, during the 1970s. This is the only complete decade after most British colonies had obtained independence, and before the 30 year cut-off date for release of the negotiation files.

## GENERAL CONSIDERATIONS

This section of the chapter briefly discusses the evidence from the archived files concerning the motivations and capabilities of tax treaty negotiators. While the nature of the evidence is more revealing about the motivations at the British end, it is also interesting to consider the British negotiators' impressions of their developing country counterparts.

### **British negotiators' motivations**

Memos circulating within Whitehall during this time support the core contention of critical scholarship on tax treaties and developing countries, that British investors were already protected from the bulk of double taxation risk through the UK's unilateral tax credit regime. In one note from December 1973, an Inland Revenue civil servant recalls how he made the case to an adviser from the Tanzanian government:

It occurred to me that where developed countries were prepared to make provision for tax sparing in their agreement there was advantage for the developing country in concluding an agreement... I pointed out that at least as far as UK businessmen were concerned there was evidence that they preferred to have a double taxation agreement in operation. It was true that there were generous unilateral reliefs available under the United Kingdom legislation but it was always possible to envisage cases where the individual taxpayer might lose out quite apart from the fact that on grounds of principle the United Kingdom would prefer to have a double taxation agreement with

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<sup>10</sup> M Evers, 'Tracing the Origins of the Netherlands' Tax Treaty' (2013) 41 *Intertax* 375.

<sup>11</sup> F Aukonobera, 'Uganda' in M Lang, P Pistone and J Schuch (eds), *The impact of the OECD and UN model conventions on bilateral tax treaties* (Cambridge University Press, 2012), 1024; NQ Cruz, 'Colombia' in Lang, Pistone and Schuch (eds), *ibid*, 204.

<sup>12</sup> For example, A Pickering, *Why Negotiate Tax Treaties?* (United Nations/International Tax Compact, Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries, Paper No. 1-N, 2013).

a developing country than to see it rely on UK investors gaining the benefit of unilateral relief.<sup>13</sup>

The topic of ‘tax sparing’ provisions will be returned to later in this chapter, but it is worth dwelling for a moment on the UK’s ‘grounds of principle’. In 1976, the Inland Revenue led a cross-Whitehall review of double taxation relief, intended to build a consensus position across departments. According to that review, ‘in the absence of an agreement there is no question of United Kingdom investors being doubly taxed’, but the benefits of an agreement, ‘include protection against fiscal discrimination, the establishment of a framework within which the two tax administrations can operate, and the expectation that an overseas authority which has negotiated a treaty will at least try to apply it reasonably.’<sup>14</sup> A subsequent memo from another official adds that, ‘protection against fiscal discrimination is generally worth more [in developing countries] because they are more likely to include deliberately discriminatory fiscal practices in their general law than are developed countries.’<sup>15</sup>

With this in mind, the Inland Revenue opposed the conclusion of any treaty with a developing country whose negotiating position would require deviation from the standards embodied in the OECD model treaty. As the examples later in this chapter will show, relatively inexperienced negotiators from newly independent developing countries did seek to challenge some of these fundamental tenets, sometimes emboldened by discussions taking place at the newly established United Nations Ad Hoc Committee of Experts. A treaty with a developing country at variance with these standards might have benefited British businesses in the short term, but would undermine a long-term project whose aim was to protect British firms from onerous taxation and, “educate” developing countries...about acceptable international fiscal standards.’<sup>16</sup>

Other Whitehall departments also took an interest in the Inland Revenue’s negotiating priorities, but with a slightly different perspective. A note within the Foreign Office, for example, describes two priorities for UK tax treaties: first, that ‘British overseas investors should enjoy the same advantages in developing countries as their rivals’ and second, that ‘taxation obstacles to private investment in developing countries should be removed.’<sup>17</sup> Similarly, a Department of Trade memo states that, ‘it is important that we should not place our traders at a disadvantage when seeking out investment opportunities.’<sup>18</sup>

### **Capabilities of developing country negotiators**

British negotiators’ comments on their developing country counterparts demonstrate that they often considered themselves to be negotiating with people whose capacity to understand the detail of tax treaties, and to drive forward discussions, was quite limited. For example, after a meeting in 1972 with ‘the only one who is able to talk about Double Taxation Agreements’ in Thailand’s revenue department, a British Foreign Office official concluded that, ‘in principle

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<sup>13</sup> Memo from J Marshall to D Hopkins, undated. File ref IR40/17624

<sup>14</sup> ‘Double taxation relief.’ Report to the Paymaster General, 25 February 1976. File ref FCO 59/1459.

<sup>15</sup> Memo from A Wilkinson, Inland Revenue, 8 April 1976. File ref IR 40/18941.

<sup>17</sup> Memo from Golden to Kerr, 10 January 1971. File ref FCO 7/2206

<sup>18</sup> Memo from Gill to Harris. 15 February 1973. File ref FCO 63/1126

they would be interested but it was not likely that Thailand would take the initiative.<sup>19</sup> Similarly, an Inland Revenue note on talks with Egypt indicates that the Egyptians ‘were willing to be led by us most of the time in the drafting.’<sup>20</sup> An initial draft treaty received from Nigeria was seen as ‘an opening bid from a country which has had little recent experience in negotiating double tax conventions’,<sup>21</sup> while a British official ‘gained the impression that the Brazilians are constantly revising their policy in light of experience and a review of the effect of the concessions granted.’<sup>22</sup>

Tanzania had a six-strong team for negotiations with Britain in February 1977, of whom the British delegation concluded that only one was ‘familiar with the detail of the Tanzanian draft.’ The delegation was led by the Deputy Principal Secretary of the Treasury, who ‘did not know a great deal about taxation but seemed an able person’ and the Commissioner of Income Tax, who was described as:

Again a very pleasant man. Knew very little about the implications of international tax agreements. Did not always display a full detailed knowledge of the Tanzanian tax system. Often slow to see points. Gave very little indication from day to day that he remembered (or cared) about what had happened earlier in discussions.<sup>23</sup>

These extracts support Charles Irish’s assertion that:

In general, the income tax departments of developing countries are woefully undertrained and understaffed and are barely able to cope with the administration of domestic tax laws, much less give serious consideration to complex international tax matters. Consequently... new tax agreements are too often the product of unquestioned acceptance of the developed country’s position after little or no substantive negotiation.<sup>24</sup>

Despite these observations, as the next section illustrates, there are examples of tough stances taken by developing countries, including some smaller countries such as Tanzania with little negotiating experience.

## CASE STUDIES

This section looks at some of the detail of individual negotiations, using correspondence between negotiators, meeting minutes, and civil service memos. It is structured along the lines of several particular sticking points for negotiators. In some instances, agreements were reached, but in others the differences in position led to a stalemate.

### Tax sparing

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<sup>19</sup> Letter from D Montgomery, British Embassy, Bangkok, 5 June 1972. File ref FCO 15/1645.

<sup>20</sup> Note on UK/Egypt Double taxation talks, May 1976. File ref IR 40/19097.

<sup>21</sup> ‘Taxation brief for Mr Barratt’s visit to Nigeria and meeting with the Director of Inland Revenue: December 1978.’ File ref IR 40/17629.

<sup>22</sup> Memo from RG Tallboys to MF Daly, undated, circa October 1971. File ref IR 40/17189.

<sup>23</sup> Minutes of UK-Tanzania negotiation meeting, 3-10 Feb 1977. File ref IR 40/17624

<sup>24</sup> Irish, above n 7, 300.

Although they do not form part of the OECD or UN model treaties, and indeed have been discouraged by the OECD since 1998,<sup>25</sup> ‘tax sparing’ clauses, often referred to as ‘matching credit for pioneer reliefs’ were at the root of many tax treaty negotiations by the UK during the 1970s that are still in force today. As the UK operated a credit, rather than an exemption mechanism for its unilateral double taxation relief, the effect of a developing country offering a tax incentive to British investors was often simply to reduce the credit they received against their UK tax bill, hence increasing their UK tax liability by an amount corresponding to the concession. Tax sparing clauses in treaties gave a matching credit against UK tax for the amount that would have been payable by a British firm in the treaty partner had it not been the subject of an investment-promoting tax incentive. This allowed investors to keep the benefit for themselves.

Tax sparing clauses were, indeed, understood by the Inland Revenue to be ‘the main cash benefit for the investor’ from a tax treaty. When, in the December 1973 conversation referred to earlier, an economic advisor to the Tanzanian government asked an Inland Revenue negotiator, ‘whether in view of the fact that most developed countries had provision for unilateral relief there was any point in developing countries concluding double taxation agreements at all since the only effect of such agreements was normally in the case of developing countries to surrender rights of taxation to developing countries’, the latter responded that tax sparing provisions were likely to be the main benefit.<sup>26</sup>

From the perspective of developing countries that wished to ensure the effectiveness of their new investment promotion incentives, the sacrifice of taxing rights entailed by a tax treaty was a price worth paying for the ‘tax sparing’ clause. Zambia, for example, was keen to give full effect to the incentives outlined in its 1965 Pioneer Industries Act. All of the 11 treaties concluded between Zambia and OECD member countries during the 1970s and 1980s provided explicitly for tax sparing credits, or else contained provisions that had the same effect.<sup>27</sup> The priority accorded to the tax sparing clause is illustrated by a formal letter sent by Zambia to the UK in 1969, requesting that negotiations be opened:

In recently negotiated Agreements, Zambia has followed substantially the O.E.C.D. Draft Convention and it is suggested that any new Agreement should substantially follow this Draft Convention. Zambia would, in particular, wish to discuss matters arising from the operation of the Zambian Pioneer Industries (Relief from Income Tax) Act.<sup>28</sup>

The UK, for its part, was an enthusiastic supporter of tax sparing clauses, as illustrated in a speaking note drafted for a meeting of Commonwealth finance ministers in August 1973:

We have taken the opportunity to offer matching credit for pioneer reliefs to all the developing countries with whom we have double taxation agreements. We also offer matching credit to any developing countries with which we enter into negotiations for the first time.<sup>29</sup>

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<sup>25</sup> OECD, *Tax Sparing: A Reconsideration* (OECD Publishing, 1998).

<sup>26</sup> Memo from J Marshall to D Hopkins, undated. File ref IR40/17624

<sup>27</sup> Two exempted dividends paid to direct investors from tax in the home country entirely.

<sup>28</sup> Communication from the Zambian Ministry of Foreign Affairs, 12 September 1969. File ref IR 40/16974

<sup>29</sup> Inland Revenue speaking note dated 24 August 1973. File ref OD 42/104.



The idea that tax sparing was a concession made by the UK to developing countries was reiterated during negotiations. The following remark by a British official, for example, is recorded in the notes of a negotiating meeting with Zambia: ‘Ministers had indicated that matching credit was a very real sacrifice by the UK and looked to see balancing concessions by the partner country in the rates of withholding taxes.’<sup>30</sup> Whitehall correspondence from the Inland Revenue to the Foreign Office concurs that:

In negotiating a Double Taxation Agreement we would naturally want to obtain a reduction in the other country’s tax rates, and we often find that the offer of matching credit for tax spared under the other country’s tax holidays is a useful bargaining counter in securing such reductions.<sup>31</sup>

Yet it was not only the governments of developing countries that were keen to obtain tax sparing agreements: British investors, and the Whitehall departments charged with championing their interests, were also interested. Correspondence within the Economic Department of the Foreign and Commonwealth Office illustrates the presence of such concerns. In a note attached to a newspaper clipping, for example, a civil servant compared the situation for British firms with those of a German competitor:

You will see that Rollei’s success depends on its capacity to exploit not only the labour cost advantages of Third World production but also two major tax advantages offered by the host country. The first tax advantage – the five-year pioneer tax holiday – is available also to British companies under a tax sparing provision in the UK/Singapore treaty. But the second tax advantage of a negligible rate of tax on export profits will still be frustrated by countervailing UK tax. Here then is an example of how the range of UK matching relief might be expanded under an existing treaty.<sup>32</sup>

Perhaps the most significant example of British industry’s interest in a tax sparing agreement is the lobbying surrounding lengthy and ultimately unsuccessful negotiations with Brazil during the 1970s. A particularly difficult issue for the UK was Brazil’s insistence that the UK grant extensive tax sparing concessions. This would mean crediting the value of a Brazilian tax exemption against the UK company’s tax bill as if it had paid full Brazilian tax, in the manner of a normal tax incentive. It would also, however, mean doing the same for the reductions in withholding taxes that were built into the treaty. In the words of a Brazilian negotiator, ‘whilst Brazil does not want the United Kingdom to lose tax, she cannot allow the United Kingdom to collect more tax as a result of the convention.’<sup>33</sup>

Several European countries, including France and Germany, had reached agreement with Brazil, which both increased the pressure on the Inland Revenue and reduced its leverage in negotiations. ‘We have already forfeited opportunities for investment in Brazil, notably to the Germans and Japan’, one official from the Board of Trade argued.<sup>34</sup> In October 1974, Department of Industry officials wrote again to the Inland Revenue citing ‘specific

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<sup>30</sup> Minutes of negotiating meeting between UK and Zambia, 24-27 May 1971, London. File ref IR40/16974.

<sup>31</sup> Letter from C Stewart, Inland Revenue. 7 December 1971. File ref IR 40/17189.

<sup>32</sup> Letter from B Tarlton, FCO. 29 March 1973. File ref FCO 59/973.

<sup>33</sup> F Dornelles, recorded in a note of talks in Brazilia, October 1974. File ref IR 40/19025

<sup>34</sup> Letter from J Gill, Board of Trade, 15 February 1973. File ref FCO 63/1126.

evidence of orders being lost by British companies [in Brazil] apparently because of their relatively lower post-tax returns forcing them to quote higher prices in compensation.’<sup>35</sup>

The Inland Revenue, reluctant even to share information on negotiations with Brazil or any other country with other Whitehall departments, nonetheless felt under pressure, which provoked considerable internal discussion.<sup>36</sup> One typical memo illustrates the Revenue’s dilemma:

the possible repercussions of our acceptance of the Brazilian proposal on credit...could be far reaching. No-one would believe that we would not be prepared to concede similar terms to all other developing countries, and the Brazilian agreement would be looked on as a model for our future agreements with those countries.<sup>37</sup>

By 1974, even the Revenue was beginning to recognise that British companies ‘are undoubtedly at a competitive disadvantage as compared with companies from other countries’, but it was still unwilling to meet Brazil’s terms for tax sparing credits.<sup>38</sup> In December, the debate between departments had reached ministerial level, beginning with a letter addressed from Secretary of State for Trade Peter Shore to Chancellor of the Exchequer Dennis Healey, to ‘place on record my strong commercial interest in concluding an agreement with Brazil.’<sup>39</sup>

This escalation to cabinet level appears to have eventually led to a partial thawing in the Inland Revenue’s resistance. The Brazilian form of tax sparing required new enabling legislation in the UK, which was eventually passed in 1976. Tax sparing was only one of several sticking points, however, and as British negotiators travelled to Brazil after gaining this new legislative mandate, instructions were cabled for them ‘to refrain from agreeing to the unacceptable features of Brazilian law which they wish to enshrine in the treaty, but to avoid a breakdown in the talks.’<sup>40</sup> The Brazil files examined for this chapter stop at the turn of the 1980s, but the pressure to conclude an agreement did not. In 1992, in a separate file, an Inland Revenue official wrote that ‘Brazil continues to be the big prize: but it is not ripe for an immediate approach and what indications there are suggest that it will be a difficult nut to crack.’<sup>41</sup>

## Shipping

The UK takes a particularly firm position on Article 8 of its tax treaties, which concerns the taxation of shipping. The OECD model tax treaty allocates all taxing rights over shipping activity to the country of residence of the shipping firm. The UN model, in contrast, includes the option of a shared taxing right, recognising that many developing countries impose a tax on the profits made by foreign shipping firms within their waters. The UK is unusual in that it has never signed a tax treaty that concedes any source taxation rights over shipping, although

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<sup>36</sup> Letter from A Smallwood, Inland Revenue, 15 March 1973. File ref FCO 59/973.

<sup>37</sup> Memo from D Hopkins, Inland Revenue, 9 November 1973. File ref IR 40/19025.

<sup>38</sup> ‘Brazil Brief 16: Double Taxation Relief Agreement’, 25 August 1974. File ref IR 40/19025.

<sup>39</sup> Letter from P Shore, 12 December 1974. File ref IR 40/19025. (In 1974 the Department of Trade and Industry was split into two separate departments)

<sup>40</sup> Telegram, 24 May 1976. File ref IR 40/19025.

<sup>41</sup> Memo from JB Shepherd, Inland Revenue, 14 July 1992. File ref IR 40/17808.

it has on occasions been willing to conclude agreements that omit the shipping article altogether, effectively leaving source taxation rights intact.<sup>42</sup> As one British negotiator explained during a negotiation with Bangladesh:

Shipping had an emotional appeal in the United Kingdom because of its importance to the economy...Shipping companies do not pay much corporation tax in the United Kingdom and might well incur losses if required to pay foreign tax.<sup>43</sup>

With Thailand, for example, the Inland Revenue had been under pressure from shipping firms to negotiate a treaty since the 1930s, because Thailand had implemented a gross basis tax on foreign shipping firms that was not eligible for credit in the UK.<sup>44</sup> Knowing that the only terms on which an agreement could be reached would contravene this longstanding UK policy, the Inland Revenue resisted this pressure, and negotiations did not open in earnest until 1974. With the Chamber of British Mines now attaching 'special importance' to an agreement with Thailand, and the Confederation of British Industry (CBI) and British Insurance Association expressing a 'strong interest',<sup>45</sup> the British made repeated requests to open negotiations, finally succeeding in 1976. Before finalising the treaty, the Inland Revenue consulted with the General Council of British Shipping (GCBS), who were concerned about the precedent the Thai treaty might set for future negotiations. A briefing note for the second round of negotiations states that, 'we have decided, after consultation with the General Council of British Shipping, to have no Shipping Article in the Convention.'<sup>46</sup> This would allow Thailand to retain its taxing rights over British shipping, without setting a precedent through a clause specifically permitting this.

Shipping was also a sticking point during unsuccessful negotiations from 1973 to 1977 with Tanzania, a coastal country in Africa whose port of Dar es Salaam is a major transport hub for central and East Africa. In negotiations in February 1977, both sides made clear that their positions on shipping taxation were a point of principle. The British notes of the meeting state that 'the Tanzanians were not in a position to negotiate as firm guide-lines had been laid down by their cabinet prior to the discussions' and that 'their political masters have forbidden any compromise on this matter.'<sup>47</sup> Tanzania pointed out that it had already obtained shared taxing rights over shipping with Norway, Sweden, Germany and Italy. More importantly, 'most favoured nation' clauses in its German and Norwegian agreements meant that, were it to concede the UK's position, the costs would cascade beyond just Tanzania's taxing rights over UK shipping.

With the stalemate over shipping risking contributing to the eventual breakdown of negotiations, the Inland Revenue consulted once again with the GCBS. As with their discussions about Thailand, the latter's key concern was precedent, but by this point the concern was more specific: the UK had recently opened negotiations with India, a big prize for both the Inland Revenue and the GCBS. A letter from the GCBS to the Inland Revenue states:

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<sup>42</sup> Hearson, above n 9.

<sup>43</sup> Minutes of negotiation between UK and Bangladesh, July 1977. File ref IR40/18445.

<sup>44</sup> File ref IR 40/17358.

<sup>45</sup> Letter from IP Gunn, Inland Revenue, 25 September 1974. File ref IR 40/18456.

<sup>46</sup> 'Double taxation convention talks with Thailand.' c. October 1976. File ref IR 40/18456.

<sup>47</sup> Minutes of UK-Tanzania negotiation meeting, 3-10 Feb 1977. File ref IR 40/17624

As to an agreement with Tanzania, it is the GCBS view that it should not contain a shipping article which accepts a reduced rate of tax on UK shipowners, even though it would rank for tax credit relief. To do so would prejudice the negotiations with India and would set a bad precedent for other negotiations.<sup>48</sup>

## **Withholding taxes**

Articles 10 to 12 of tax treaties state maximum rates at which the country of source can levy withholding taxes on dividends, interest and royalty payments, and in some cases fees for management, technical and consultancy services. The OECD model provides for exclusive residence taxation of royalties and management fees, and while most tax treaties allow for some source taxation of royalties, this is much rarer in the case of management fees. For newly independent developing countries, especially those keen to attract investment as part of a policy of import substitution industrialisation (ISI), withholding taxes became increasingly important tools to raise revenue, prevent profit-shifting tax avoidance, and also to incentivise investors to reinvest capital, rather than repatriating it.

In Zambia, for example, around one third of investible surpluses were removed from the country, creating considerable political debate.<sup>49</sup> In 1973, as Zambia began to introduce withholding taxes on various forms of cross-border payment, President Kaunda delivered a speech criticising foreign-owned mining companies, because, ‘in the last three and a half years...they have taken out of Zambia every ngwee [penny] that was due to them.’<sup>50</sup> As well as dividend repatriation, Kaunda complained that government agreements with the mining companies permitted them to shift profits out of Zambia by providing ‘sales and marketing services for a large fee. Although most of this work is performed in Zambia the minority shareholders have entered into separate arrangements with non-resident companies for reasons best known to themselves.’<sup>51</sup>

The same was true of the East African Community countries, Kenya, Tanzania and Uganda, with which the UK negotiated during the late 1960s and early 1970s. After years of increasing health and education spending by politicians keen to demonstrate success to a fledgling electorate, these countries faced a budget crisis, to which they responded with a dramatic overhaul of their tax regimes, including the imposition of withholding taxes as high as 40 per cent.<sup>52</sup>

All three countries had inherited agreements put in place by the colonial administration, which prevented them levying withholding taxes on some forms of cross-border payment. While Kenya had agreed to extend this colonial-era treaty until a new one had been negotiated, Tanzania and Uganda had let theirs lapse. Tax administration had been a shared function of the three countries for a time after independence, and a treaty had been initialled in 1969 by the Commissioner of the East African Income Tax Office. It was rapidly abandoned by all three countries once these new taxes were put in place. The new

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<sup>48</sup> Letter from TS Donaghy to B Pollard, 11 March 1977. File ref IR 40/18456.

<sup>49</sup> A Seidman, ‘The Distorted Growth of Import-Substitution Industry: The Zambian Case’ (1974) 12 *The Journal of Modern African Studies* 601, 611.

<sup>50</sup> Quoted in A Sardanis, *Zambia: The First Fifty Years* (IB Tauris, 2014) 97.

<sup>51</sup> Quoted in *ibid.*

<sup>52</sup> L Gardner, *Taxing Colonial Africa the Political Economy of British Imperialism* (Oxford, Oxford University Press, 2013) 238–241.

negotiations were difficult, dragging on for many years, and in the end the only agreement secured was with Kenya, ratified in 1976.

Much of the difficulty concerning these negotiations rested with the withholding tax rates, which are summarised in Table 1. In January 1972, a British tax treaty negotiator in Nairobi sent a telegram to his superiors informing them that, ‘talks with Kenya have broken down over treatment of management fees and royalties. The Keanyans [sic] have pressed me to obtain confirmation from the Board that the UK cannot agree to a 20% withholding tax.’<sup>53</sup>

As with President Kaunda’s concerns in Zambia, the notes of the UK-Kenya negotiations indicate that Kenya’s concern about management fees related to tax avoidance by British multinational companies. Pressed for an example, Kenyan negotiators explained that a British firm had posted handwritten letters back to the UK, where they were typed up and posted back to Nairobi, with an inflated fee charged for this secretarial service.<sup>54</sup> Participation in discussions at the United Nations Group of Experts had also emboldened Kenya, as the following record of comments from two of its negotiators illustrates:

Mr Cropper said that there had been a big change in developing countries’ attitudes in the UN Group of Experts...Mr Ihiga said that modern thinking was that a withholding tax on management fees was justified.<sup>55</sup>

**Table 1: Kenyan withholding tax rates, actual and proposed**

|   | <b>Portfolio dividends</b> | <b>FDI dividends</b> | <b>Interest</b> | <b>Royalties</b> | <b>Management fees</b> |
|---|----------------------------|----------------------|-----------------|------------------|------------------------|
| <b>Colonial treaty</b>                    | 0                          | 0                    | No restriction  | 0                | No restriction         |
| <b>UK-EAC initialled treaty</b>           | 15                         | 5                    | 15              | 10               | 0                      |
| <b>New Kenyan domestic law</b>            | 12.5                       | 12.5                 | 12.5            | 20               | 20                     |
| <b>Original UK proposal for treaty</b>    | 15                         | 5                    | 10              | 0                | 0                      |
| <b>Original Kenya proposal for treaty</b> | 30                         | 20                   | 25              | 40               | 40                     |
| <b>Final agreed in treaty</b>             | 15                         | 15                   | 15              | 15               | 15                     |

Source: negotiating correspondence

Kenya injected an additional sense of urgency by repudiating the colonial agreement in May 1972, causing concern among British businesses. Meanwhile, the UK was also facing a strong demand for a management fees clause from Jamaica, where, in correspondence between the Chancellor of the Exchequer and the Jamaican Minister of Finance, the latter had

<sup>53</sup> Telegram from D Hopkins, Inland Revenue, 27 January 1972. File ref IR 40/17623

<sup>54</sup> Minutes of UK-Kenya tax treaty negotiation meeting, London, 9-11 November 1971. File ref IR 40/17623

<sup>55</sup> Minutes of UK-Kenya tax treaty negotiation meeting, Nairobi, 25-29 January 1972. File ref IR 40/17623

‘expressed his concern about the way in which profits were being drained from Jamaica in the form of management fees and similar payments.’<sup>56</sup>

The turning point in the UK’s approach seems to have been a meeting with representatives of British businesses in March 1972, in which a key area of discussion was the demand from Jamaica and Kenya.<sup>57</sup> The business representatives reassured the Revenue that they were not overly concerned by this concession, and it was soon after that the UK wrote to Jamaica and Kenya informing them that it was willing to agree. The eventual treaty permitted Kenya to tax management and consultancy fees paid to the UK, but only at rates up to 12.5 percent, and with an option to be assessed on a net basis.<sup>58</sup> While the UK had relented on a point of principle, this was (and remains, at the time of writing) the lowest cap on management fees in any Kenyan treaty in force.

The outstanding sticking point in the Kenya negotiations then became the rate of withholding tax on interest, where the parties differed by only five percent, as well as pensions and Kenya’s desire to include the concept of ‘limited force of attraction’ discussed at the UN Group of Experts, which would have given Kenya greater rights to tax the net profits of British firms made within its borders. According to a British official working for the Kenyan government, civil servants in Kenya were happy to concede, ‘the difficulty was convincing the Permanent Secretary and the Minister to accept the rates.’<sup>59</sup>

The political salience of the withholding taxes is emphasised by the following exchange from the fourth round of negotiations, in April 1973:

Mr Hopkins [for the UK] asked whether the 2.5% on Royalties was more important than the force of attraction principle. Mr Gheewala [for Kenya] replied that this was correct although it would not mean as much revenue. It was a political matter in Kenya.

The new agreement was initialled and signed in 1973, but not ratified until 1976, with further concessions from the UK, including a watering down of the UK’s net basis clause within the management fees article. According to a ministerial briefing, this was because British exchange controls reduced the benefit of the treaty to Kenya, and because other countries had cited certain provisions of the UK treaty as a precedent when negotiating with Kenya.

Nigeria offers a further example of negotiations over withholding taxes on management fees. Negotiations began in earnest when Nigeria announced the abrogation of all its colonial era tax treaties in 1978, and the concurrent imposition of new taxes on air and shipping companies.<sup>60</sup> A telegram from the Inland Revenue to the British embassy in Lagos noted that the government ‘is very concerned at serious implications of termination of Double Taxation Agreement for British airline and shipping companies’, and asked the embassy to request immediate renegotiations ‘in view of the strength of representation already being

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<sup>56</sup> ‘Background note for Minister of State’, undated. File ref IR 40/18990.

<sup>57</sup> Minutes of meeting between Inland Revenue and CBI, 15 March 1972. File ref IR 40/18109.

<sup>58</sup> United Kingdom-Kenya double taxation agreement, 1973, Article 13.

<sup>59</sup> Note of meeting with E Cropper in Somerset House, 21 July 1972. File ref IR 40/17623.

<sup>60</sup> The note terminating the Nigeria-UK treaty is dated 29 June 1978. File ref IR 40/17629.

made here at senior official level and the probability of escalation to Ministerial level in the near future.’<sup>61</sup>

In the Inland Revenue’s view, the draft subsequently received from Nigeria, ‘would require us to make concessions which are far in advance of the terms which other developing countries have accepted in treaties with us.’<sup>62</sup> Progress was made in the first round of talks, but at the second round soon after February 1979 it became apparent to British negotiators that ‘an agreement on the terms offered would have been unattractive in itself and would have served as an unfortunate precedent for future agreements.’<sup>63</sup>

The main concern was the rate of tax that could be imposed on fees for technical consultancy and management services, on which Nigeria had declared what one of its negotiators explained was a ‘total war’.<sup>64</sup> The British economic arguments against taxation of management fees carried little weight because Nigeria’s position was to use tax to discourage their payment at all. The Revenue discussed the situation in confidence with the CBI, who ‘share our reluctance to reach an agreement until the Nigerians make concessions.’<sup>65</sup> The UK position did not change after this, but Nigeria did moderate its position after encountering a united front from OECD countries on this point, and a new treaty was eventually signed in 1987.

While in many ways these accounts of negotiations concerning withholding taxes can be seen as simple cases of compromise between two sides, the matter of management fees constitutes an abandonment of a point of principle by the UK. From a position of absolute rejection, its *volte face* beginning with Jamaica and Kenya in 1972 seems to have been something of a damascene conversion, at least for some years to come. It subsequently signed more treaties including a clause permitting source taxation of management fees than any other OECD member.<sup>66</sup> By 1984, an Inland Revenue official was writing to a colleague elsewhere in Whitehall that, rather than fighting its inclusion, ‘[o]ur current practice with particularly source-minded countries, as in South America, is to include such an article in our initial draft.’<sup>67</sup>

## CONCLUSION

Previous research on tax treaties between developed and developing countries has focused on the balance struck by the developing country between the sacrifice of taxing rights and the revenue promoting effect of relieving double taxation. This chapter has illustrated a number of ways in which this picture can be modified, considering both the position of the UK and that of the developing countries with which it negotiated.

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<sup>61</sup> Draft telegram, Inland Revenue, 27 July 1978. File ref IR 40/17629.

<sup>62</sup> ‘Taxation brief for Mr Barratt’s visit to Nigeria and meeting with the Director of Inland Revenue: December 1978’. File ref IR 40/17629.

<sup>63</sup> Letter from AP Beauchamp, Inland Revenue, 18 May 1979. File ref IR 40/17630.

<sup>64</sup> Letter from DO Olorunlake, Nigerian Federal Inland Revenue Services Department, 17 April 1979. File ref IR 40/17630.

<sup>65</sup> ‘Extract from briefing for Chancellor re meeting with Sir David Steel on Tuesday 10/7/79.’ File ref IR 40/17630.

<sup>66</sup> Hearson, above n 9.

<sup>67</sup> Letter from Allen, Inland Revenue, to Greaves, FCO, 17 August 1984. File ref IR 40 17808.

To begin with, developing countries frequently did not depart from a negotiating position determined through complete information, rationally analysed. In cases such as Egypt and Thailand, limited negotiating capacity in the developing country meant that the treaty largely followed UK priorities. In others, such as Tanzania and Kenya, the firmest negotiating positions were determined not by strict calculations of the revenue considerations, but by the political salience of certain clauses, often not the most significant in revenue terms. Variables such as these are idiosyncratic, but it may not be too much of a stretch to suggest that negotiated settlement in a typical treaty negotiated by a developing country during this era sacrificed more taxing rights than a fully competent, purely rational, experienced and autonomous negotiator might have achieved.

Further complicating the picture is both sides' interest in concluding treaties with 'tax sparing' clauses. In negotiations between the UK and many developing countries, such as Kenya, Brazil and Zambia, both sides appeared to understand tax sparing clauses as concessions made by the developed country in the interests of the developing country, which is logical since a tax sparing clause entails a revenue cost for the residence country. Reviewing the correspondence within the British civil service reveals, however, that British businesses were also very keen to secure tax sparing clauses, and more generally to obtain the protection and lower withholding tax rates resulting from a tax treaty. In countries such as Brazil and Spain, where their competitors were from countries that had already secured such agreements, British businesses lobbied hard for the UK to conclude one too. Developing countries might, thus, have underestimated their negotiating hands.

A final way in which this chapter suggests an alternative perspective on negotiations is the extent to which precedent was important to both sides. For some developing countries, this was institutionalised through most favoured nation clauses. For the UK, provisions with a relatively trivial revenue impact became much more important, to the extent that they jeopardised whole treaties, because of the precedent they would set for negotiations with much larger countries. Indeed, for the Inland Revenue, certain provisions were a non-negotiable point of principle, because they deviated from the standards developed within the OECD. On occasion, British officials expressed frustration when other OECD members broke ranks.

Many of the treaties discussed in this chapter, including those between the UK and Egypt, Thailand, Kenya and Nigeria, are still in force today. In the 30 to 40 years since they were signed, the UK's tax system has undergone radical changes, in particular a move towards a territorial approach that renders tax sparing credits unnecessary. This on its own suggests that a re-examination of tax treaty networks is in order. The insights from the archives provide further impetus for such a review: as well as considering the treaties themselves, present day policymakers and negotiators in developing countries should revisit their assumptions about their predecessors' motivations and capabilities in creating their enduring tax treaty networks.