International Tax Law & Tax Treaties

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Agenda

- Introduction
- Domestic tax systems for cross border activities
- Tax treaties
  - Role of tax treaties
  - Application and interpretation issues

International Tax Systems

Jurisdiction to Tax (Principles*)

- Residence
- Source

Tax Systems

- Worldwide
- Territorial

*These are the two main ways in which States exercise their jurisdiction to tax, but there exists
other ways in which a State may exercise its jurisdiction to tax – such as the United States, that taxes its 'citizens' on worldwide income.

Concept of Residence

Residence Principle

The jurisdiction to tax is based on a connection between the person/entity and the State

Physical Presence | Personal Attachment | Economic Ties | Citizen

Head Office | Place of Management | Incorporation | CM&C

Sets of Criteria

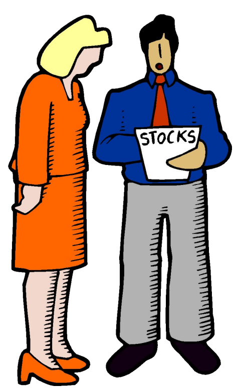
Formal

Factual

Concept of Source

Source Principle

The jurisdiction to tax is based the income being from a source within the State



<u>Examples</u>

Physical location of asset

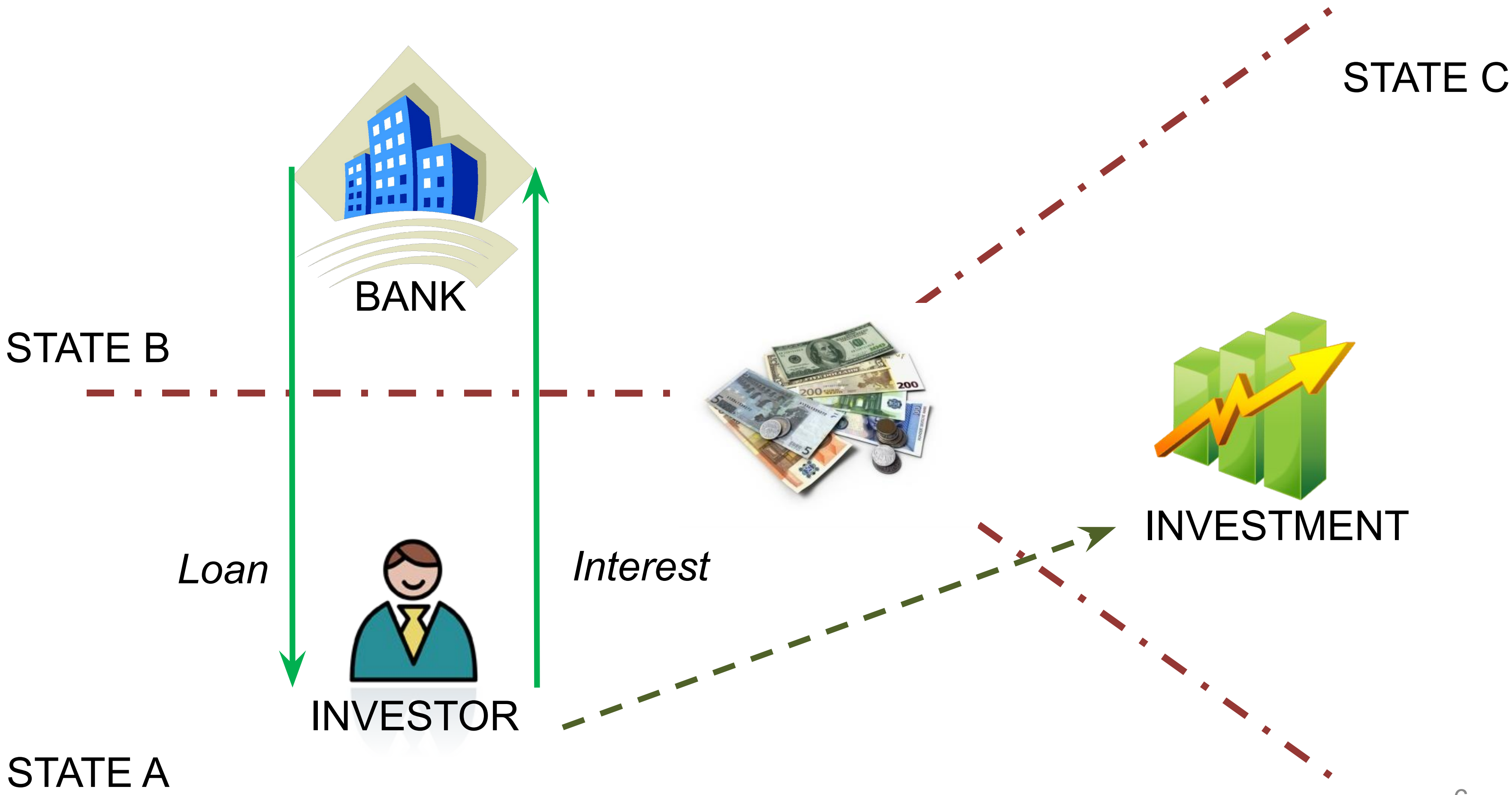
Where capital is invested

Where the payer resides

Where the contract is signed

Potential Difficulty

Issues with determining/defining source…



Design of International Tax Systems

Worldwide Taxation System

A State subjects to tax:

(1) **Residents** on their **worldwide** income (i.e. income from all sources)

(2) **Non-Residents** on income derived from **sources** within the State

This is the most common tax system around the world

Examples: Australia, New Zealand, Italy, German, Spain, UK, Canada and many more…

Design of International Tax Systems

Territorial Tax System

A State subjects to tax both **residents and non-residents** on **income derived from sources within the State**

Example: Hong Kong

Introduction

Taxation of Cross Border Activities

Example

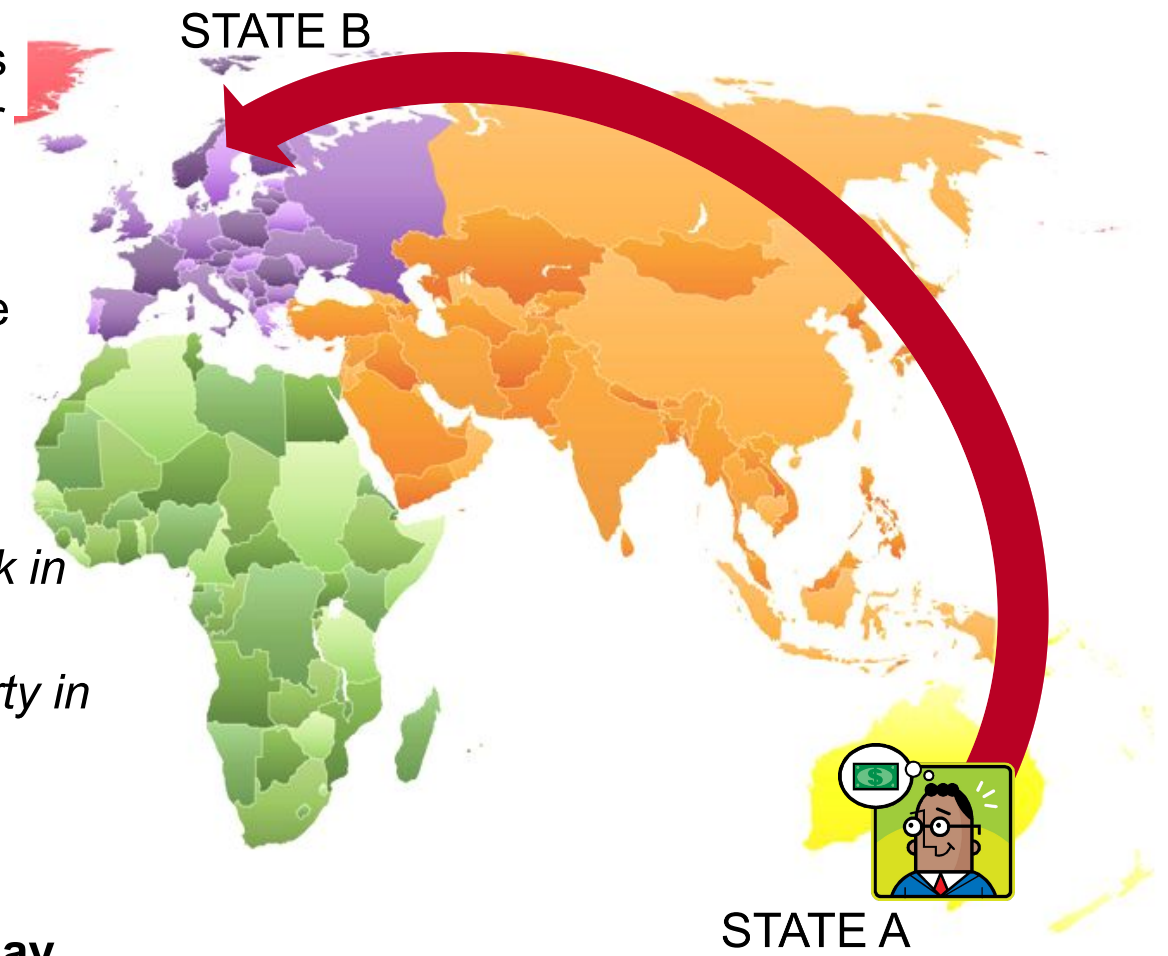
Brett, a Citizen of State A, is transferred by his employer to its subsidiary in State B for a 2 year period.

State A and State B both operate worldwide taxation systems.

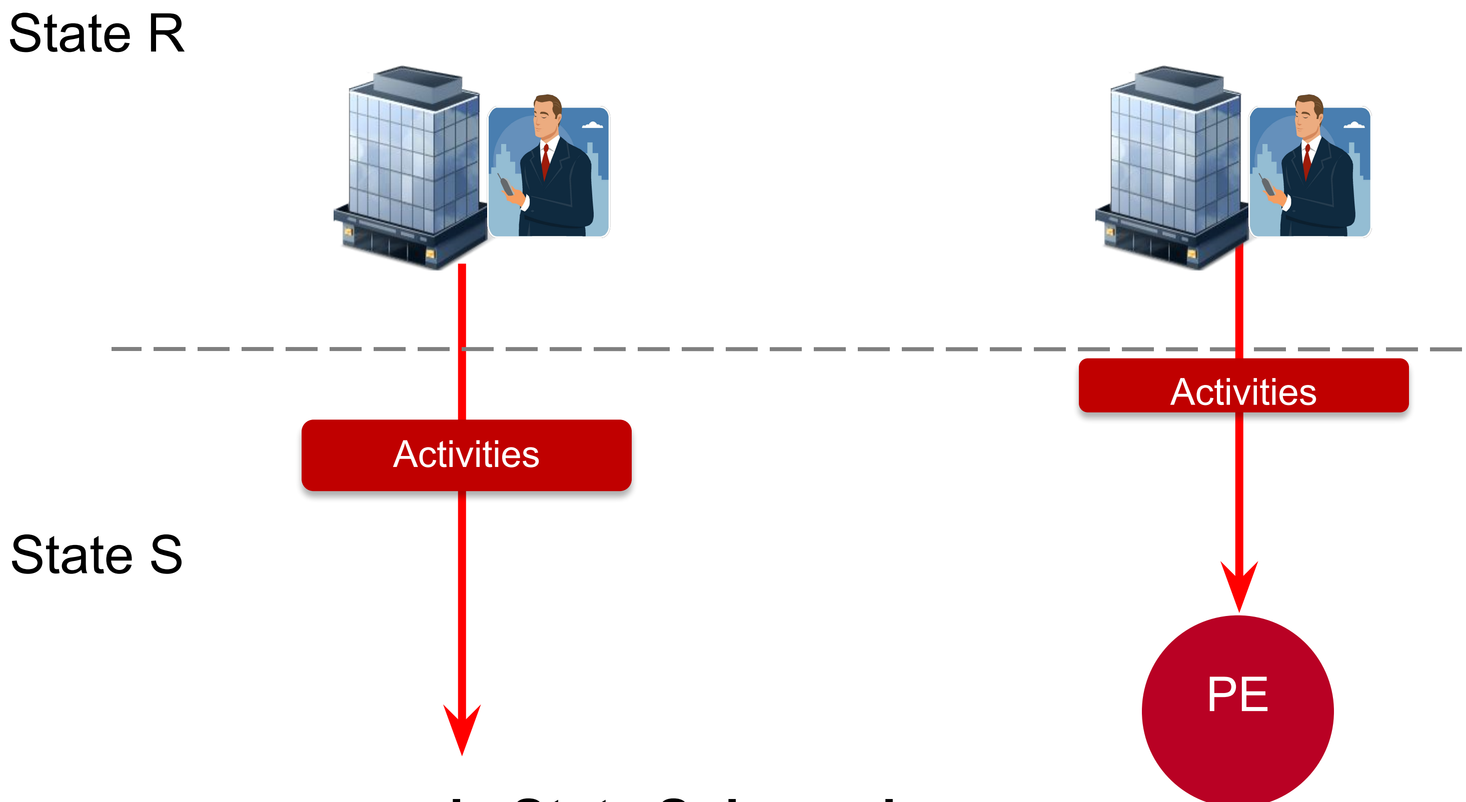
Brett's income steams include:

- *Interest on deposit with a Bank in State A*
- *Rental income from his property in State A*
- *Employment income*

What are the tax issues that may arise for Brett?



Cross Border Business Activities



Tax consequences in State S depends on

- Concept of "source"

- Threshold requirements

- Profit measurement rules

- Tax treaties

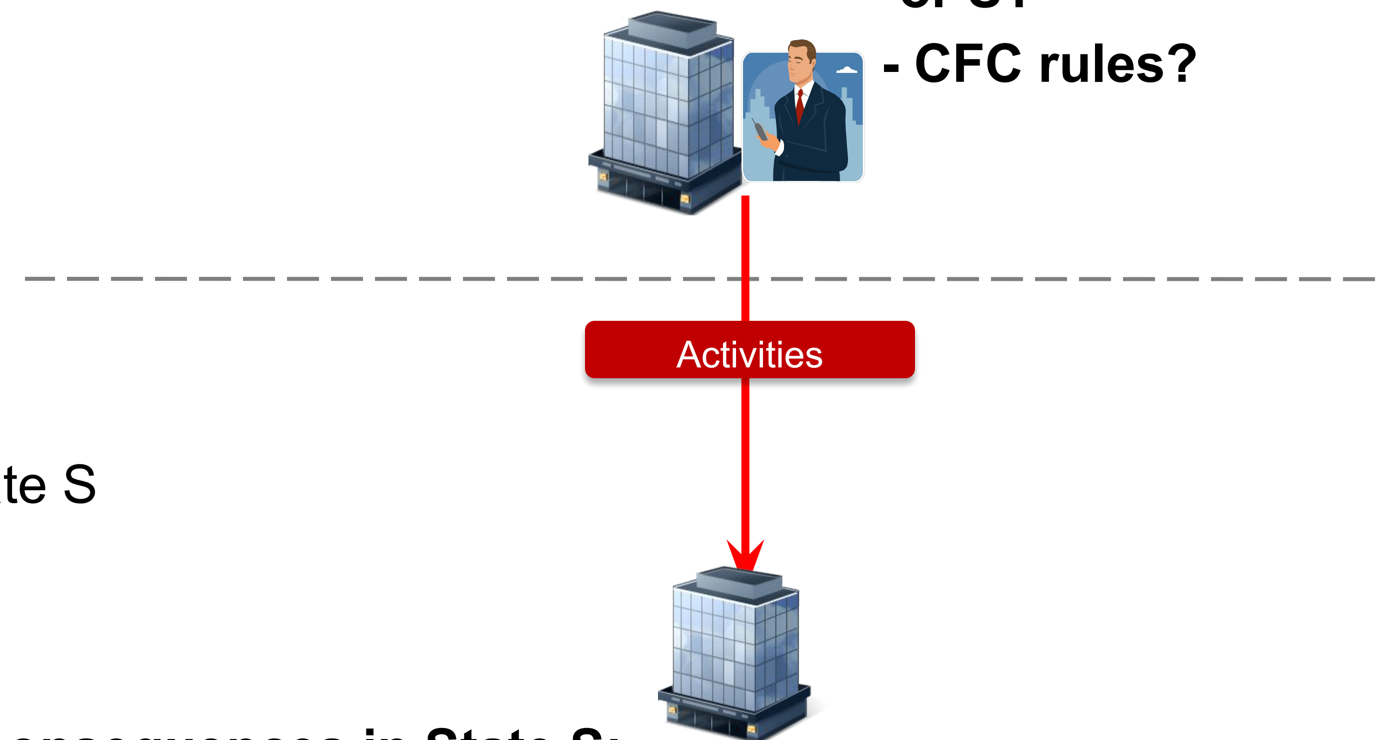
Business Activities - Subsidiary

Tax consequences in State R:

- Subsidiary resident in State R or S?

- CFC rules?

State R



State S

Tax consequences in State S:

- Subsidiary resident in State S?

- Resident taxable on worldwide income, etc.

Cross Border Employment

John is seconded to a client of PharmaCo for 4 months in order to train the staff of the client for the use of new software.

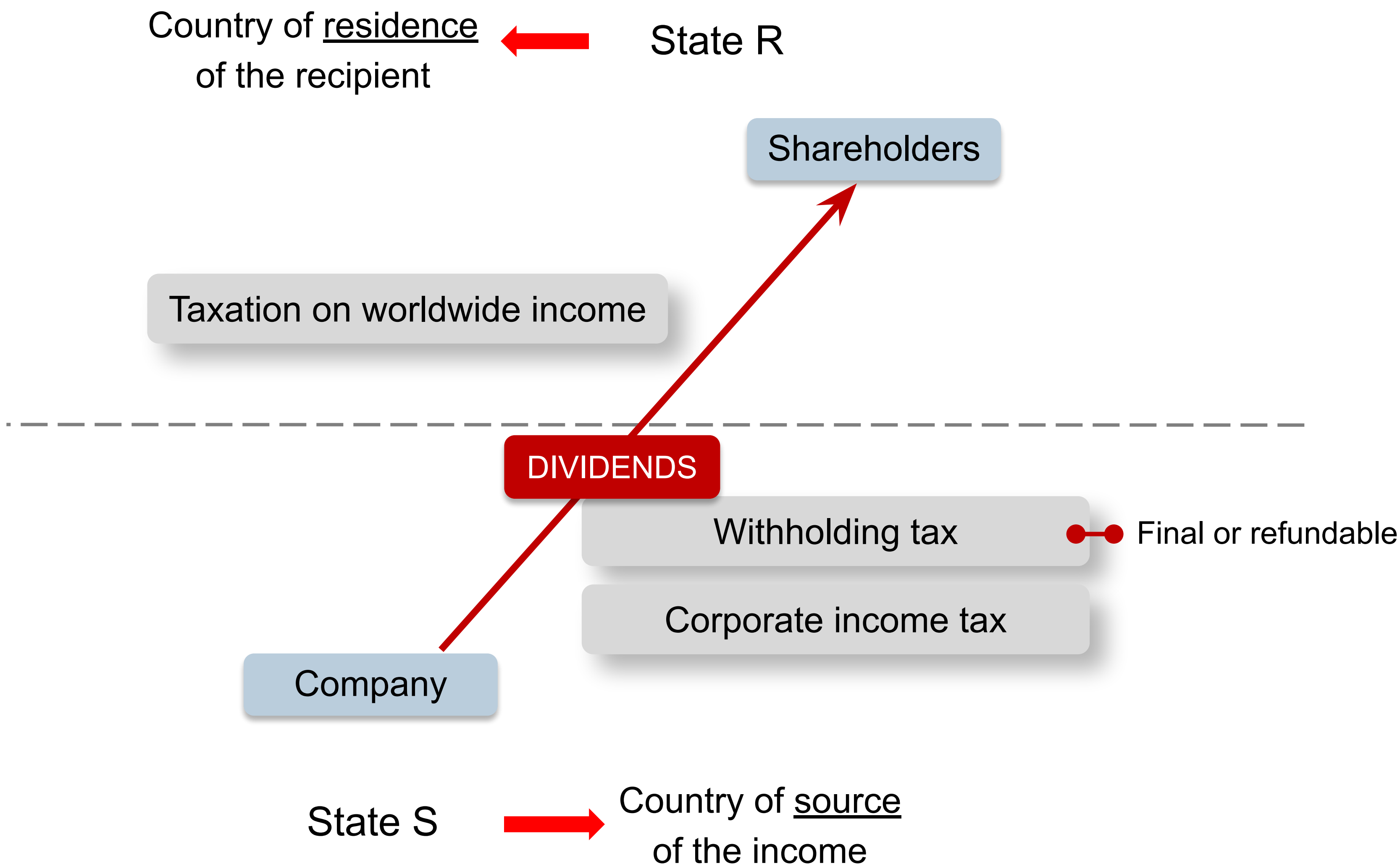
Residence State

Work State

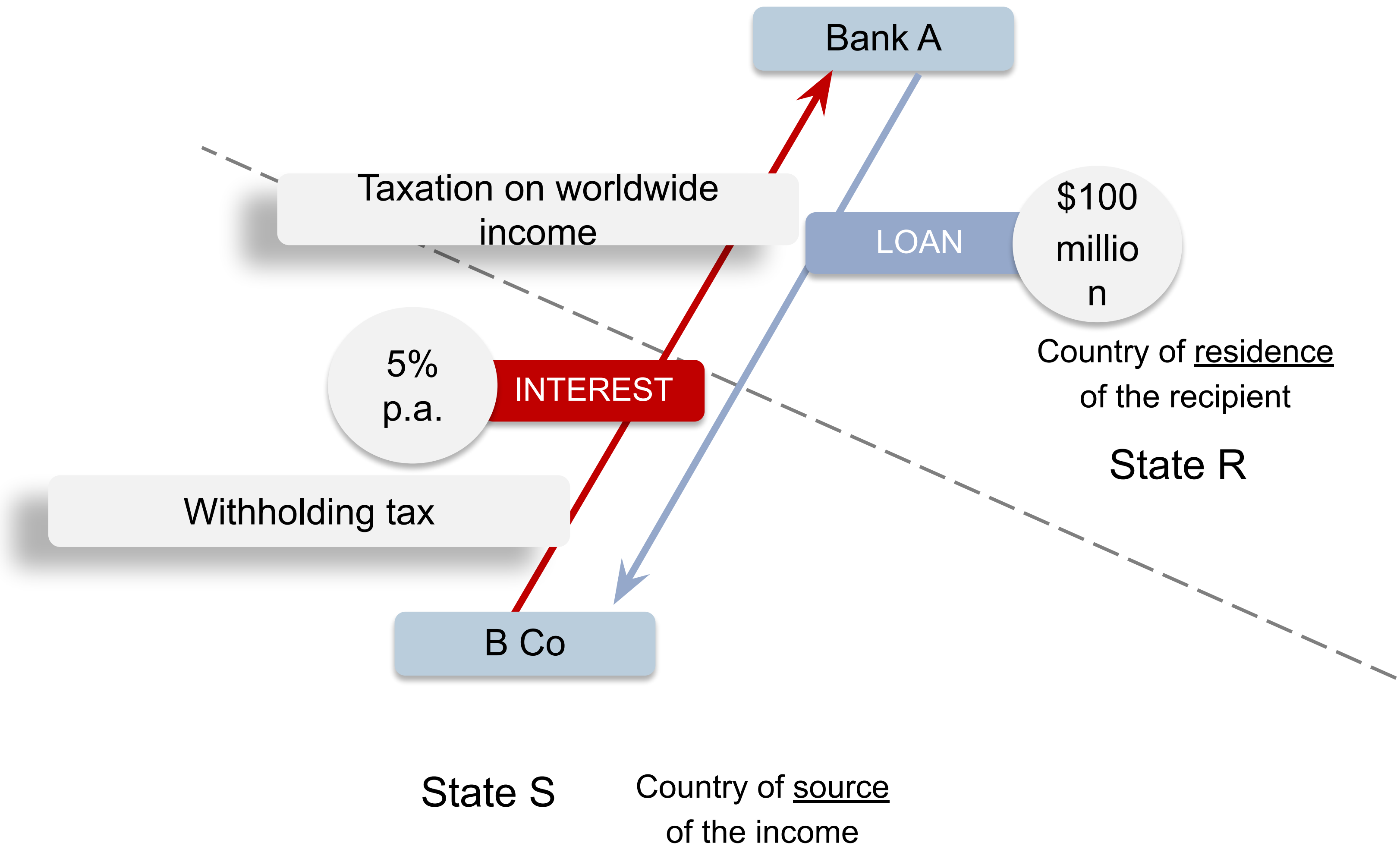
PCO

SCO

Taxation of cross-border equity investments



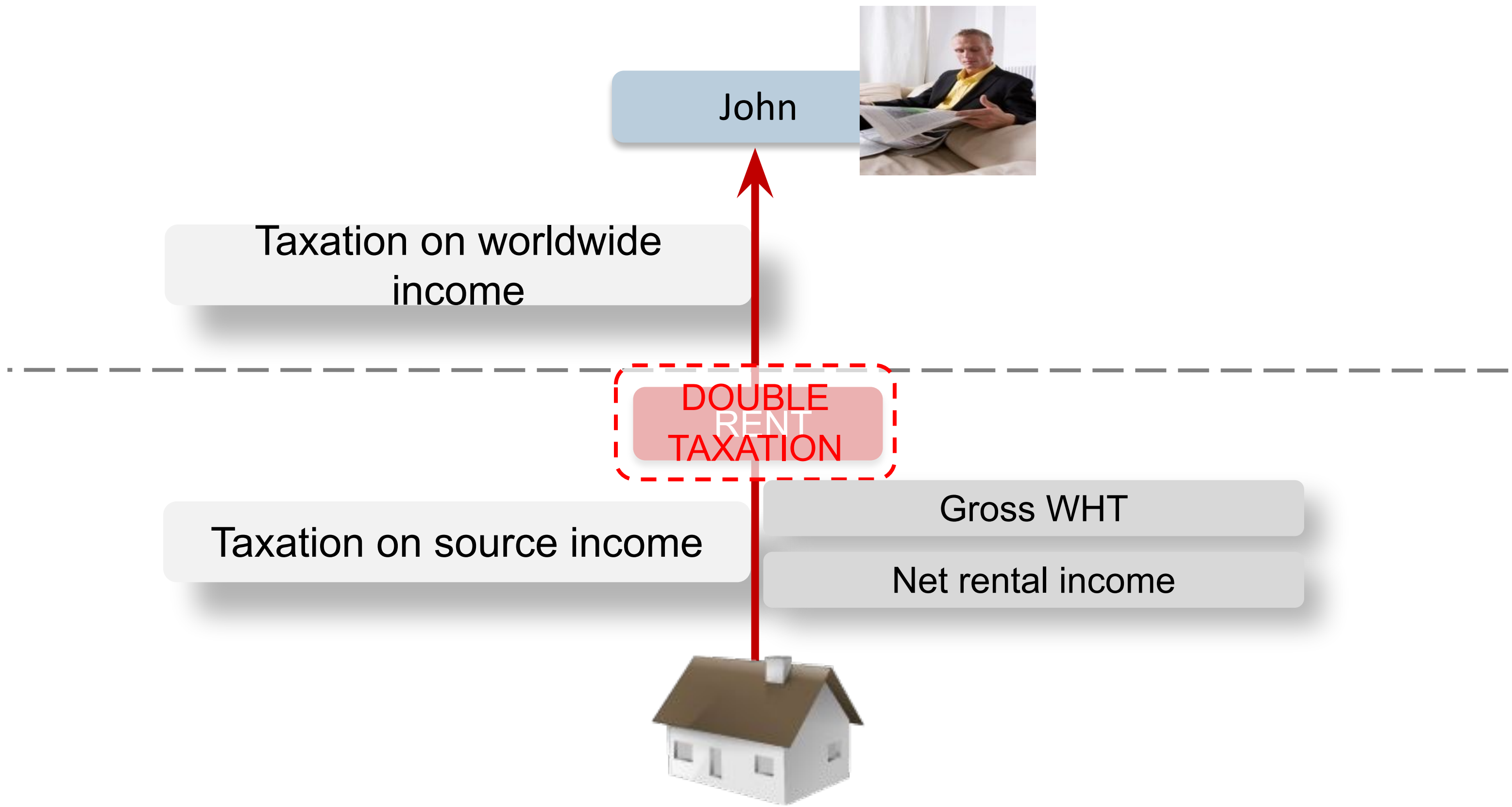
Cross border debt investments



Income from immovable property

State R

Country of <u>residence</u>
of the recipient



State S

Country of <u>source</u>
of the income

Types of Double Taxation

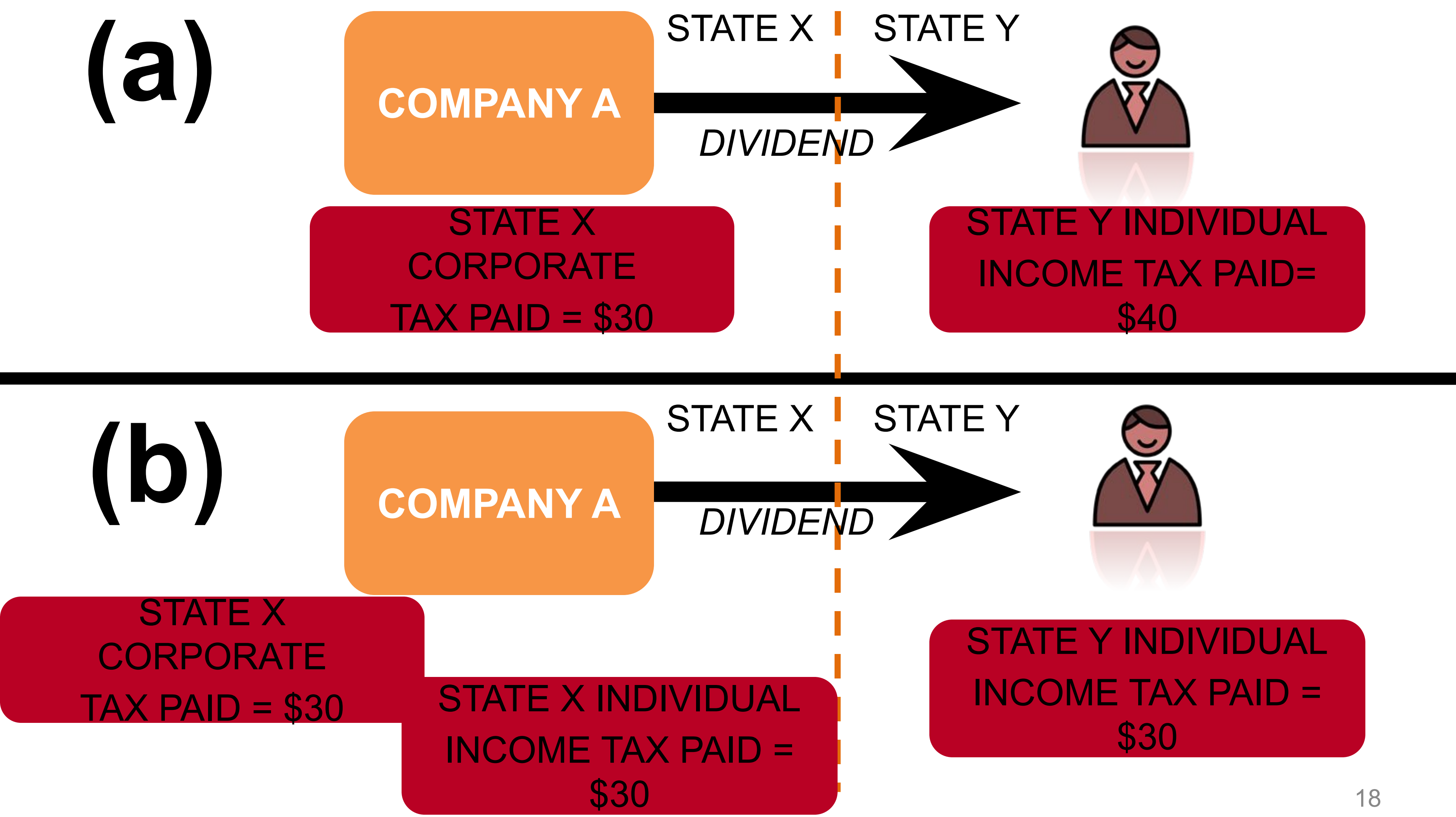
I) Juridical Double Taxation (JDT)

The same taxpayer is taxed twice on the same income

II) Economic Double Taxation (EDT)

More than one taxpayer is taxed on the same income (e.g. distributed profits)

Quiz: Juridical or Economic?



Approaches to Double Tax Relief

Capital Import Neutrality

Neutrality is viewed from the perspective of the State where the investment is made. The same tax burden should apply to foreign investors as to local investors investing in the same State

Capital Export Neutrality

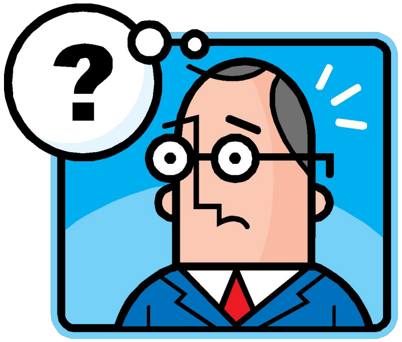
Neutrality is viewed from the perspective of the residence State of the investor – the same tax burden should apply to companies investing abroad as those investing domestically

Tax Treaties

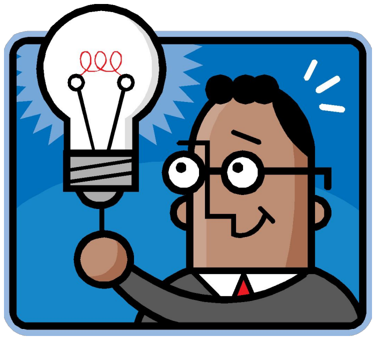
Taxation of Cross Border Activities

<u>Issue: Double Taxation</u>

Why is it an issue?



Solutions?



Taxation of Cross Border Activities

Tax treaties as a solution?

- Agreement between States (Contracting States)
- Avoidance of Double Taxation
- Coordinate the exercise of taxing rights by the Contracting States (allocation of taxing rights)
- Although it is an agreement between the States, it has direct effect towards taxpayers – “invoke treaty benefits”

Tax Treaties

- Vienna Convention on the Law of Treaties. Art. 2:

  A treaty is an international agreement in one or more instruments, whatever called concluded between states and governed by international law

Tax Treaties

- Relation Treaties (International Law) – Domestic law
  - Monism
  - Dualism

Place of Treaties in the Legal Systems

Place of treaties in the legal system of a state depends on the country's view on international law

- Most countries: treaty prevails over domestic law
- Some countries (e.g. US): treaty equals domestic law

- States in EU are free to conclude tax treaties
- But in case of conflict, EU law prevails over tax treaties

Vienna Convention on the Law of Treaties

- Article 26 VCLT *Pacta sunt servanda*
  - Binding and must be performed in good faith
- OECD report on Tax Treaty Override (1989)
  - No treaty override
  - Seek bilateral or multilateral solutions to tax treaty problems

Tax Treaties - Objectives

- General:
  - Facilitate cross-border trade and investment eliminating tax impediments

Tax Treaties - Objectives

- Operational:
  - Elimination of double taxation
  - Prevention of tax evasion

Tax Treaties - Objectives

Aims of tax treaties

- "The Avoidance of Double Taxation"

  Focus on solving juridical double taxation

- "The Prevention of Fiscal Evasion"

  OECD Model - not in the text, but in the Commentary;

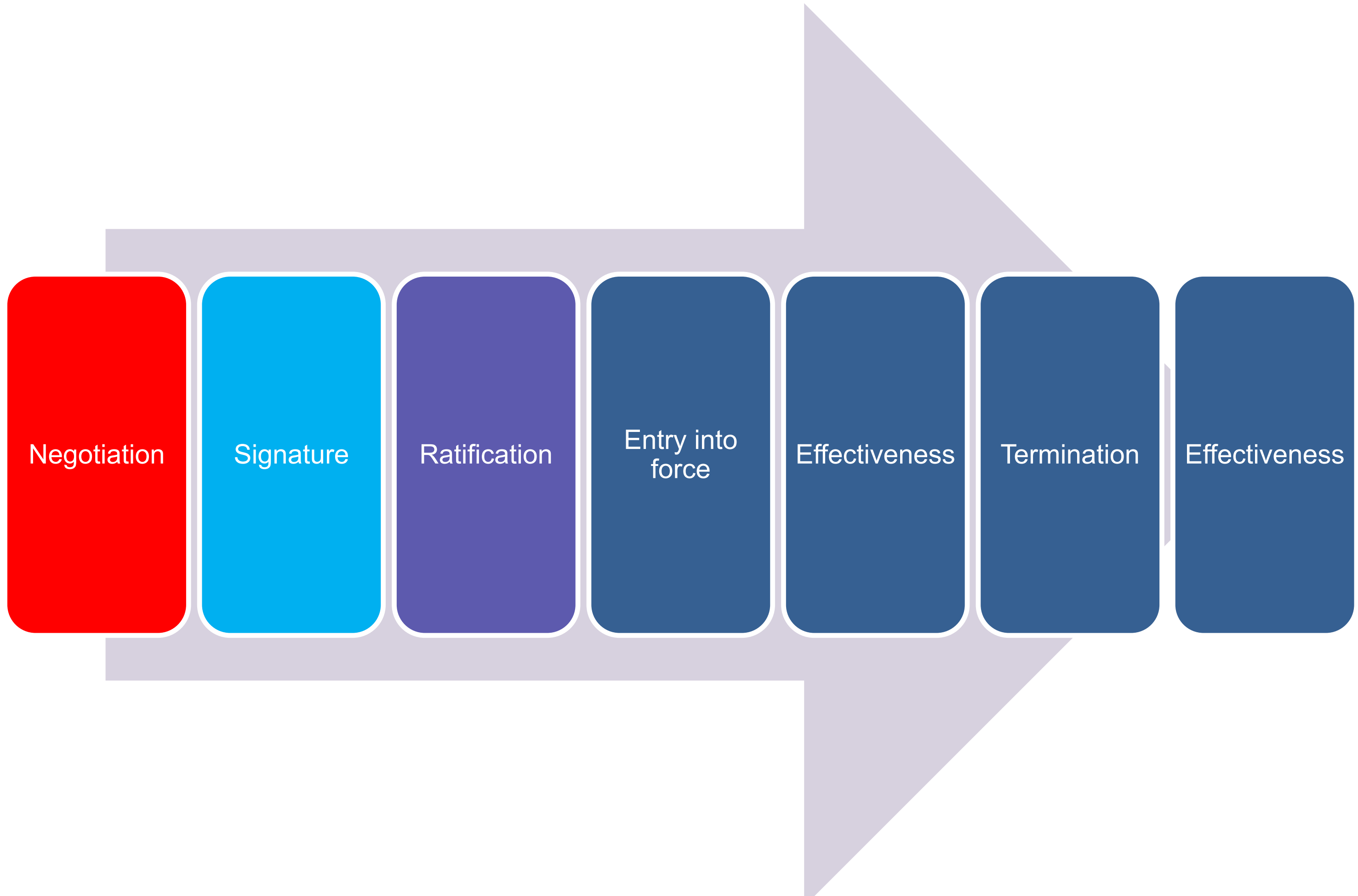
  US DTA's - "No double non-taxation intended" is in the text

Tax Treaties - Objectives

- Ancillary:
  - Elimination of discrimination
  - Exchange of information
  - Administrative assistance
  - Resolve disputes

Process of Establishment

A tax treaty is a formal agreement between two or more States, with the following life-cycle:



Model Conventions

- What is a Model Convention?

- What is a Commentary to a Model Convention?

- Why do we need a Model Convention and a Commentary?

- What is the legal value of a Model Convention and its Commentary?

Model Conventions

- League of Nations Models 1928 – 1946
- OECD Model 1963, 1977, 1992 and beyond
- UN Model 1980, 2001 and 2011
- CIAT Model
- ASEAN Model
- Andean Group Model
- National models (e.g. USA, Netherlands)
- ILADT
- USA Model 1996, 2006, 2016

Models

- OECD
- UN
- USA

Models

- OECD MC
  - Draft 1963
  - Revised 1977, 1992, 1994, 1997, 2000, 2002, 2008, 2010, 2014...
  - Commentaries
  - Favours capital exporting countries

Models

- UN Model Treaty
  - First published 1980
  - Revised 2001
  - Revised 2011
  - Commentary

Models

- OECD vs UN Model Treaty
  - UN Model follows the pattern of OECD MC
  - Main difference: UN Model imposes fewer restrictions to the source country

Models

- US Model Treaty (1996, 2006, 2016)
  - Reflects USA = Capital exporting country
    - All citizens are tax residents
    - Broad notion of business profits
    - LOB clause
    - Credit method

TAX TREATIES - Content

- Coverage, Scope and Legal Effect
- Business income
- Employment & Personal Services
- Immovable property income & CG
- WHT on investment income
- Other income
- Non-Discrimination, MAP, Exchange of information

Content/ Chapters in a Model Tax Treaty

I. Scope of the treaty (Articles 1, 2 and 29)

II. Definitions (Articles 3 to 5)

III and IV. Distributive rules (Articles 6 to 22)

- Exclusive allocation of taxing rights
- Shared allocation of taxing rights

V. Elimination of double taxation (Article 23)

- Exemption (Article 23A); Credit (Article 23B)

VI. Special provisions (Articles 24 to 29)

- Procedural rules (Articles 25, 26 and 27)
- Principles (Articles 24 and 28)

VII. Final provisions (Articles 30 and 31)

Application and interpretation of tax treaties

1ST STEP: Domestic Law

Which countries want to tax?

- First, only look at the domestic law of the countries involved
- Assess which countries want to tax under their domestic law

Do not jump directly to the tax treaty application

2nd STEP: Treaty applicable?

Art. 1 OECD MC (Persons Covered)

"*This Convention shall apply to* ***persons*** *who are* ***residents*** *of one or both* ***Contracting States***".

- Person (Art. 3(1) (a)): individual, company and any other body of persons
  - Company (Art. 3(1) (b)): body corporate or entity treated as body corporate for tax purposes
- Resident (Art. 4): a person who is liable to tax in a State by reason of his domicile, residence, place of management or a similar criterion
  - Liable to tax

Art. 4: Resident

Art. 4 OECD/UN Model

- Starting point is domestic legislation of Contracting States (Art. 4(1) OECD/UN)
- Not a resident if subjected only in respect of income from sources with a state, Art. 4(1)
- For treaty purposes, only resident of 1 State, therefore tiebreaker rules in Art. 4(2) for individuals and 4(3) for companies

Persons covered and Entity Qualification

Treaty applicable to:

Permanent establishments?

Entities generally (characterization: transparent, opaque, hybrid, check the box; consequences)?

Partnerships?

Pension funds/charities?

Governments / governmental bodies?

Diplomats?

Art. 2: Taxes Covered

- Art. 2(1) OECD: taxes on income (and capital)

- Irrespective of levying body
  - Central government
  - State/province
  - Municipality

- Exceptions/additions

Art. 29:Territorial Scope

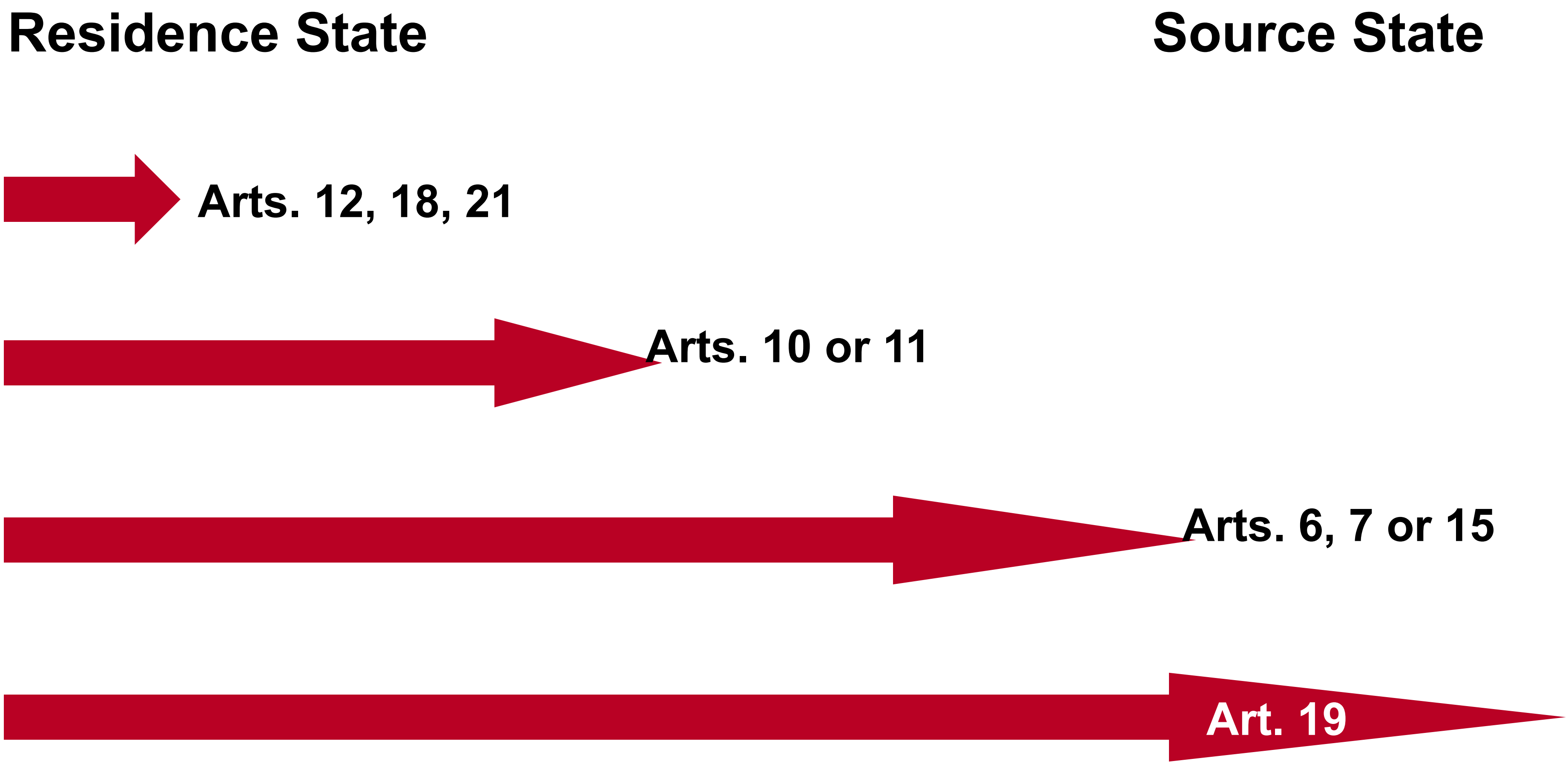
Contracting State:

- Land territory
- Territorial waters
- Continental shelf
- Exclusive economic zone

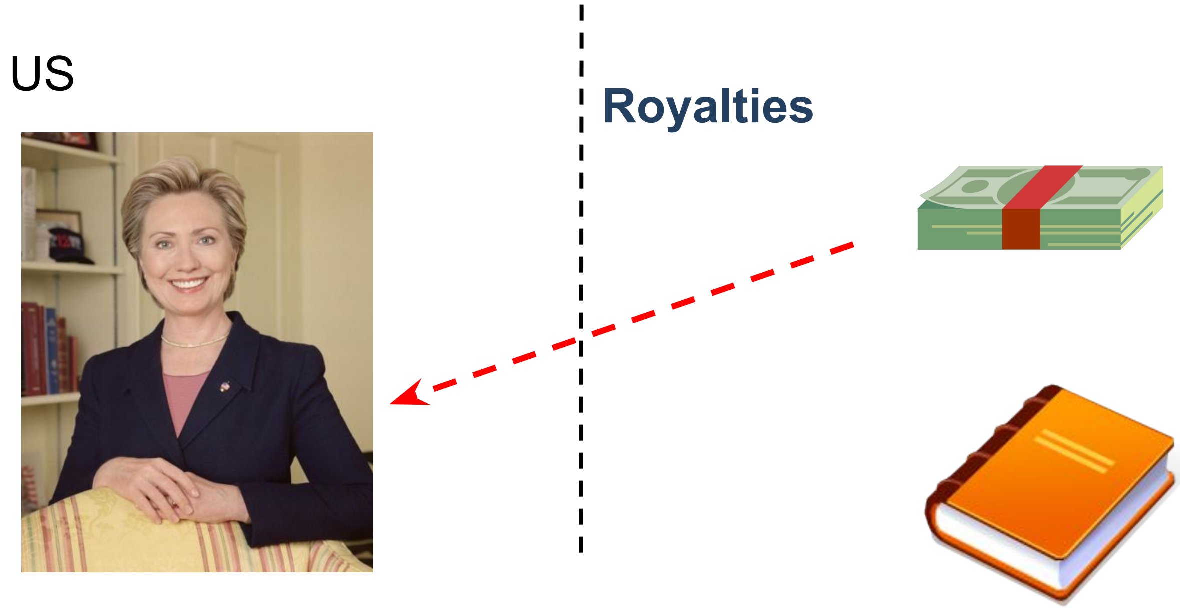
3rd STEP: Which distributive rule is applicable?

- Purpose: allocation of taxing rights between the “Residence State” and the “Other State”.
- Distributive rules are contained in Chapter III OECD MC from Art. 6 to Art. 21.

OECD Model Taxation Rights

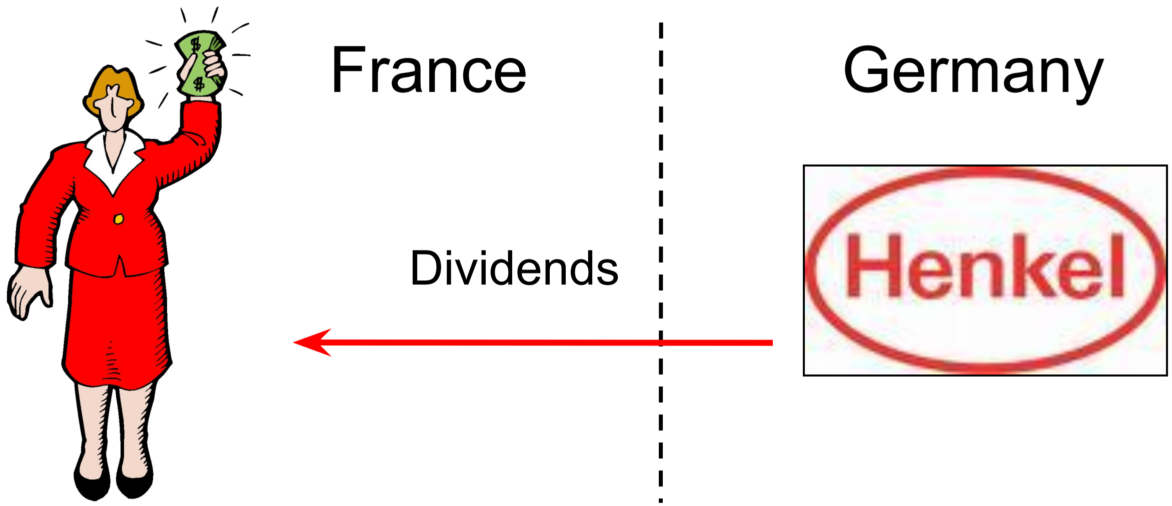


Article 12(1) OECD



Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State **shall be taxable only** in that other State.

Article 10 OECD



Para. 1

Dividends paid by a company which is resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

Para. 2

However, such dividends may also be taxed in the Contracting State in which the company paying the dividends is a resident… but … the tax so charged shall not exceed:

a) 5 per cent.... Or b) 15 per cent...

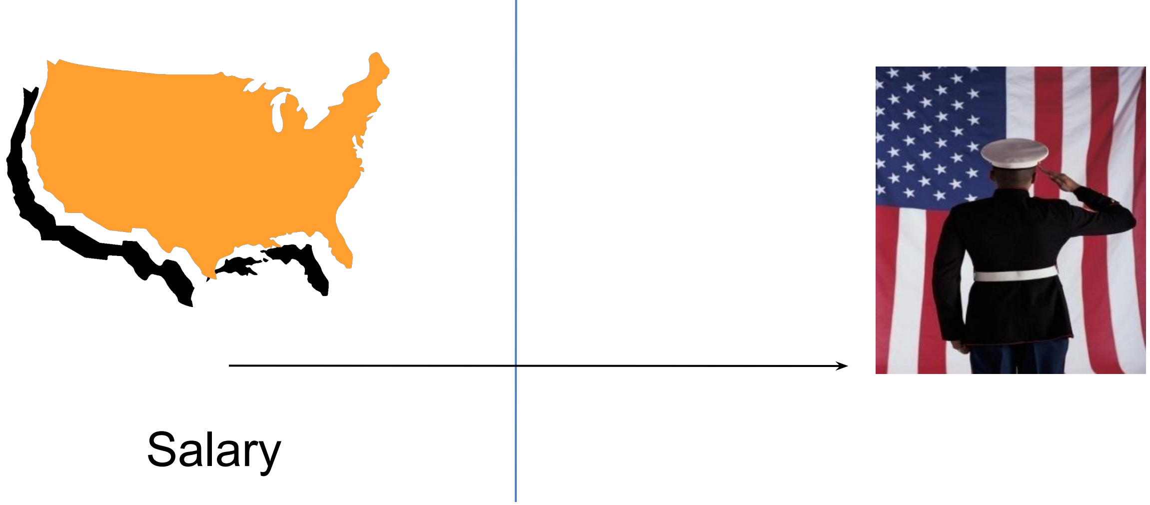
Article 6(1) OECD

Russia

Spanish Costa del Sol

Income derived by a resident of a Contracting State from immovable property … situated in the other Contracting State may be taxed in that other State.

Article 19(1) OECD



Salaries … paid by a Contracting State … to an individual in respect of services rendered to that State … shall be taxable only in that State.

4^{th} STEP: Interpretation Issues?

- Customary law
- Vienna Convention on the Law of Treaties (VCLT)

Meaning of Terms

- Article 31
  - Interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
  - Context includes any agreement or instrument related to the treaty
  - Any subsequent agreement or practice
  - Special meaning

4th STEP: Interpretation Issues?

- Art. 31(1) of the VCLT:

“A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose”.

TAX TREATIES

- Art. 31(2) of the VCLT:

*The **context** for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*

a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;

b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty

TAX TREATIES

– Art. 31(3) of the VCLT:

There shall be taken into account, together with the context:

a) subsequent agreements between the parties regarding the interpretation of the treaty or the application of its provisions;

b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation

C) any relevant rules of international law applicable in the relations between the parties

TAX TREATIES

– Art. 32 of the VCLT:

*“Recourse may be had to **supplementary means of interpretation**, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:*

a) leaves the meaning ambiguous or obscure; or

b) leads to a result which is manifestly absurd or unreasonable

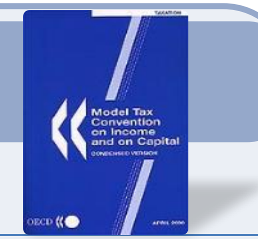
4^{th} STEP: Interpretation Issues?

Chapter II and III contain definitions of some Treaty terms:

- Art. 3 (General Definitions)
- Art. 4 (Resident)
- Art. 5 (Permanent Establishment)
- Art. 6.2 (Immovable Property)
- Art. 10.3 (Dividends)
- Art. 11.3 (Interest)
- Art. 12.2 (Royalties)
- If no definition: Art. 3, par 2 (domestic law) and general interpretation rules like in Vienna Convention

Internal Rule of Interpretation - Article 3(2)

OECD & UN Model Tax Convention on Income and on Capital



As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

4th STEP: Interpretation Issues?

- OECD MC. Interpretation
  - Commentaries
    - Reservations
    - Observations

4^{th} STEP: Interpretation Issues?

- Legal status of the OECD MC and its Commentaries?:
  - Supplementary means of interpretation (Art. 32 VCLT)?
  - Context (Art. 31 VCLT)?

Role of OECD Commentary

- Much debated!!
- Qualify as supplementary means
- Courts have demonstrated willingness to pay attention to the Commentary
  - Wording of the treaty provision must correspond to OECD Model
- Can it apply to non-OECD countries?
- Can 2008, 2010 & 2014 updates be applicable to treaties entered into before 2008?

4th STEP: Interpretation Issues?

- OECD & UN Models:
  - Internal rule of interpretation Art. 3(2) & Commentaries
    - Static approach
    - Ambulatory approach

Supplementary Means of Interpretation

- Article 32 of Vienna Convention
- History of treaty provisions
- Expert evidence
- OECD Model and Commentary
- OECD Studies
- Legislative history of treaty
- Foreign court decisions
- Tax authorities' pronouncements
- Literature/Authors

5th STEP: Distributive Rule and Relief

Three possible outcomes:

- Residence State has an exclusive right of taxation (for e.g. Art. 12 OECD MC)
- The Other State has an exclusive right of taxation (for e.g. Art. 19.2 OECD MC)
- Both States taxes the income (for e.g. Arts. 6, 10, 11 OECD MC) but the Residence State has to grant relief under Article 23

Article 23 – Elimination of Double Taxation

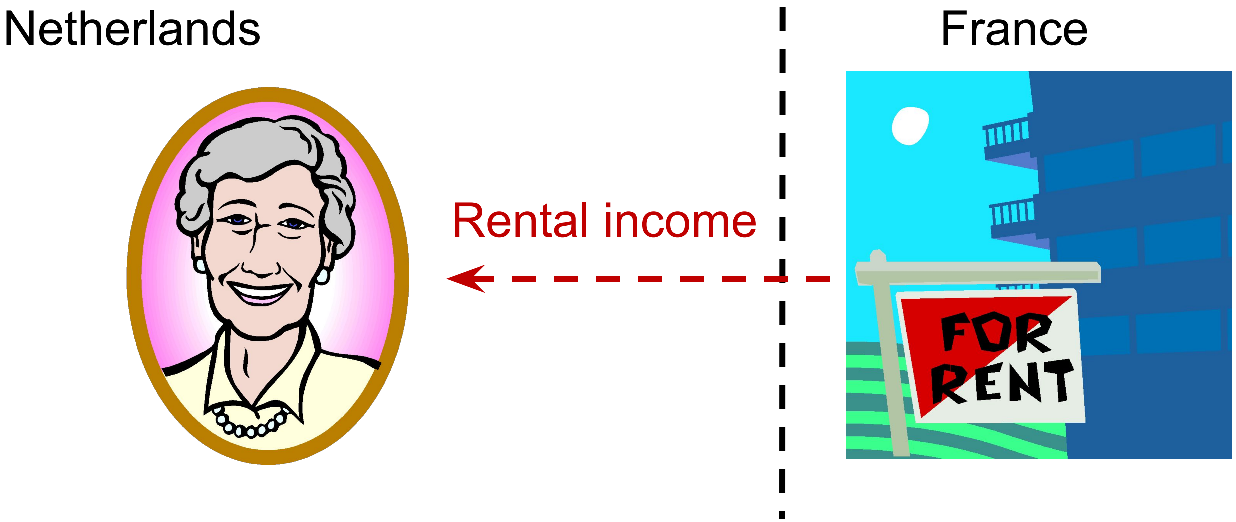
Exemption method

- Full exemption
- Exemption with progression

Credit method

- Full credit
- Ordinary credit

Example of Exemption with Progression



Mariette has a small apartment in France that she rents out in the summer. She receives 100 rental income. Under the France-NL tax treaty, the income is exempt under the exemption-with-progression in the Netherlands. She receives 100 as pension income from the NL.

Example

Income brackets	Tax rate
0-100	0%
100-200	10%
200-300	30%
300 and above	40%

How much will Mariette pay and where?

Example of Credit Method

France | Germany

Dividends

Henkel

Dividends received: 100
WHT in Germany (15%):
Net income:
Income taxable in France
French IT (40%)
Foreign tax credit:
French tax payable:
Total tax paid: =

Recap of Tax Treaty Application

- Step 1: Domestic law
- Step 2: Treaty applicable?
- Step 3: Which distributive rule is applicable?
- Step 4: Interpretation issues?
- Step 5 : Application of the distributive rules and relief

Latest text of the treaty?

- In force/in effect/not terminated?

Has the treaty been amended?

- Amending Protocol/exchange of notes/application of MFN clauses?

Treaty languages

- Official or unofficial translation?
- Deviation between versions in official languages?

Position subsequent law

- Treaty override?
- Other treaties (e.g. WTO, Investment Protection Agreements or Free Trade Agreements)?