

**United Nations Handbook**  
on Selected Issues in

# **Administration of Double Tax Treaties**

for Developing Countries



United Nations

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# **United Nations Handbook** on Selected Issues in **Administration of** **Double Tax Treaties** for Developing Countries

Edited by

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## Preface

Over the past decade, the relationship between the mobilization of financial resources for development and international tax cooperation featured prominently in the outcome documents of major United Nations conferences and summits on economic and social matters. These include the 2002 Monterrey Consensus, the 2008 Doha Declaration on Financing for Development, as well as the outcomes of the 2009 Financial Crisis Conference and the 2010 MDG Summit. In the Doha Declaration, for instance, Member States recognized multi-lateral, regional and national efforts aimed at improving developing countries' abilities "to negotiate mutually beneficial investment agreements" and "to promote good tax practices."<sup>1</sup>

Tax treaties play a key role in the context of international cooperation in tax matters. On the one hand, they encourage international investment and, consequently, global economic growth, by reducing or eliminating international double taxation over cross-border income. On the other hand, they enhance cooperation among tax administrations, especially in tackling international tax evasion.

Developing countries, especially the least developed ones, often lack the necessary expertise and experience to efficiently interpret and administer tax treaties. This may result in difficult, time-consuming and, in a worst case scenario, ineffective application of tax treaties. Moreover, skills gaps in the interpretation and administration of existing tax treaties may jeopardize developing countries' capacity to be effective treaty partners, especially as it relates to cooperation in combating international tax evasion. There is a clear need for capacity-building initiatives, which would strengthen the skills of the relevant officials in developing countries in the tax area and, thus, contribute to further developing their role in supporting the global efforts aimed at improving the investment climate and effectively curbing international tax evasion.

Tax treaties, and model conventions, generally do not include any guidance on how the provisions of treaties should be applied,

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<sup>1</sup>A/RES/63/239, annex, paras. 16 and 25.

leaving this matter to the domestic law of the contracting States. Although there is a vast and growing body of literature, and ample supply of training materials dealing with the substantive provisions of tax treaties and the relationship between them and the provisions of a country's domestic law, relatively little assistance is available regarding the practical application of tax treaties. This Handbook, resulting from a joint project of the Financing for Development Office of the United Nations Department of Economic and Social Affairs and the International Tax Compact, is intended to contribute to filling this gap.

How do tax treaty provisions apply in practice? This question is addressed by the ten chapters comprising this Handbook. They were written by international tax experts, benefiting from extensive consultations with numerous experts from the National Tax Authorities and Ministries of Finance of developing countries. The Handbook describes best practices of countries in administering their tax treaties and identifies common denominators to the extent possible. The emphasis is on the practices of the tax authorities of developing countries. Their experts may be in a better position to assist other developing countries with less experience in this area, because they followed a similar path, often not so long ago. An effort is made to keep the material basic and practical and to focus on the procedural aspects of applying the treaty rather than on its substantive rules.

This publication was conceived, written, discussed, revised and published during a seven-month period, thanks to the enthusiasm and commitment of all involved. We hope that it serves to stimulate further discussions on the topic of the administration of tax treaties, including at capacity-development events organized by international organizations active in the area of international tax cooperation.

A handwritten signature in dark ink, appearing to read 'A. Trepelkov', with a stylized flourish at the end.

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Director, Financing for Development Office  
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Alex Trepelkov, Harry Tonino and Dominika Halka  
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## Introduction

This book is a result of a project, undertaken jointly by the Financing for Development Office (FfDO) of the United Nations Department of Economic and Social Affairs and the International Tax Compact (ITC), aimed at strengthening the capacity of National Tax Authorities and Ministries of Finance in developing countries to effectively identify and assess their needs in the area of tax treaty negotiation and administration. The financial contribution for the project was provided by the German Federal Ministry for Economic Development and Cooperation (BMZ). Within the FfDO, the project was implemented, by a small team led by the Director, Mr. Alexander Trepelkov, and comprising Ms. Dominika Halka and Mr. Harry Tonino, Economic Affairs Officers, with the administrative support of Ms. Victoria Panghulan.

The ultimate goal of this project was to support the development of a comprehensive set of capacity-building tools to be used in developing countries, which would be demand driven, reflect adequately the needs of these countries, and complement the existing capacity tools.

The project was launched in December 2012. As the first step, two simultaneous technical meetings were held in Rome, Italy, on 28-29 January 2013, with the participation of 25 representatives of the National Tax Authorities and Ministries of Finance from developing countries, representing all the regions of the world. The discussion on the administration of tax treaties, held within several thematic sessions, was facilitated by selected members of the Committee of Experts on International Cooperation in Tax Matters (the Committee) and representatives of several international and regional organizations. National experts were frank in sharing their countries' experiences and concerns. The discussion contributed to: (i) identifying the needs of developing countries in the area of tax treaty administration and taking stock of the available capacity development tools at their disposal; and (ii) determining the actual skills gaps and challenges faced by developing countries in administering their tax treaties. A report of the meeting, which summarizes the main findings and details priority areas for the purposes of developing relevant capacity-building activities and tools to address these issues, is available at <http://www.un.org/esa/ffd/tax/2013CBTTNA/Summary.pdf>.

One practical outcome of the Rome meeting were the “terms of reference” for a series of technical papers, which would address the specific issues in the administration of tax treaties of interest and concern to developing countries. These terms of reference were identified and agreed upon by the national participants in the meeting. Accordingly, the draft papers were prepared by several international tax experts and underwent a peer review

These papers were then presented by the authors for discussion during the technical meeting, held in New York, on 30-31 May 2013, with the participation of 32 representatives of the National Tax Authorities and Ministries of Finance of developing countries. Each paper was discussed in a separate session, which was chaired by a member of the Committee or by a representative of the relevant international or regional organization. Following a presentation by the author, a designated lead discussant representing a developing country was invited to comment on the paper, focusing on the specific experience of their country. This was followed by an open exchange of views among all the participants. During the discussion, there were many practical suggestions on how the papers would better meet the realities of developing countries’ tax administrations. The South-South sharing aspect emerged very prominently. The participants from the developing countries engaged in an intense discussion among themselves, offering advice and sharing best practices to countries with less experience in negotiating and administering double tax treaties. A view was expressed that experts from developing countries were often in a better position to assist other developing countries than experts from developed countries, as they followed a similar path, often not so long ago.

Following the meeting, the authors revised their papers taking into account feedback received from other experts. The papers were then finalized and edited to comprise this *UN Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.

The *UN Handbook* will be launched and distributed at the OECD Meeting with non-OECD Economies and International Organizations preceding the 18th Annual Tax Treaty Meeting, which will be held in Paris, on 25 September 2013.

The e-version of this UN Handbook will be available free of charge at [http://www.un.org/esa/ffd/documents/UN\\_Handbook\\_DTT\\_Admin.pdf](http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf).

As next steps, FfDO is envisioning organizing, together with partners, an annual Forum on Administration of Tax Treaties and other capacity-development events, based on the *UN Handbook*, with a view to promoting South-South sharing in the area of current issues in the administration of double tax treaties.



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## Chapter I

# An overview of the issues involved in the application of double tax treaties

BRIAN J. ARNOLD\*

### 1. Introduction

Over the last few decades, the number of bilateral tax treaties has increased dramatically. The United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>1</sup> (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>2</sup> (OECD Model Convention) provide models for countries to use in negotiating the terms of their treaties and are regularly updated. The United Nations Model Convention was most recently revised in 2011 and the OECD Model Convention in 2010.<sup>3</sup> Developing countries are increasingly entering into tax treaties with developed and other developing countries in order to facilitate cross-border trade and investment. Although there is a vast and growing body of literature dealing with the substantive provisions of tax treaties and the relationship between those provisions and the provisions of a country's domestic law, relatively little information is available about the practical application of tax treaties.

This chapter is intended to provide an overview of the issues involved in applying the provisions of bilateral tax treaties. In this

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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

<sup>2</sup>Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

<sup>3</sup>Any references to the United Nations Model Convention and Commentary are to the 2011 version, unless otherwise noted. Similarly, any references to the OECD Model Convention and Commentary are to the 2010 version, unless otherwise noted.

regard, it provides an introduction to the other chapters in this Handbook, which deal in more detail with the most important aspects of the application of tax treaties. In general terms, the application of the provisions of tax treaties involves questions that are ancillary to the substantive rules in the treaty, and are related to how a taxpayer obtains the benefits of the treaty. Often these ancillary questions involve procedural issues, such as filing and information requirements and the burden of proof.

There is no generally accepted definition of what is involved in the application of the provisions of tax treaties. In general, the term “application” is used to indicate that the focus is not on what the provisions of the treaty say, but how they are applied in a procedural sense. Therefore, one way to view issues involved in the application of tax treaties is to differentiate between the substantive rules of the treaty and the procedural aspects of applying those rules. This distinction is not completely clear, however, because substantive and procedural issues sometimes blend together. For example, the substantive provisions of a treaty require interpretation before they can be applied. This interpretive aspect of tax treaties can be considered to relate to the substance of the provisions or to their application, or to both. Nevertheless, for the purposes of this overview, a discussion of treaty interpretation has been excluded.

This chapter begins with a discussion of the different ways in which countries implement tax treaties into their domestic legal systems because the method of implementation may affect the requirements that countries impose on taxpayers seeking to obtain the benefits of a tax treaty. It then examines the rules provided in tax treaties that govern the way in which the provisions of the treaties are applied. In general, few rules of application are provided in the treaties themselves. For the most part, tax treaties leave the method for the application of the provisions of the treaties up to the domestic law of the contracting States. Therefore, the next section deals with the provisions of domestic law dealing with the application of tax treaties. It includes a discussion of how tax authorities determine whether taxpayers qualify for treaty benefits, how the treaty benefits are provided, and how the tax authorities of countries deal with the application of tax treaties from an organizational viewpoint. The chapter then discusses in general terms how the provisions of tax treaties are applied

by a country to its residents and to residents of the other country. The application of the provisions of tax treaties in light of a country's anti-avoidance rules presents special difficulties that are discussed briefly in the final section.

Although this chapter deals with practical issues in the application of tax treaties generally, it focuses in particular on the needs of developing countries, which often have less experience with tax treaties than developed countries. While the United Nations Model Convention and Commentary provide guidance to developing countries concerning the substantive provisions included in their treaties, they do not provide much guidance with respect to the problems faced by developing countries in applying their treaties. This Handbook is intended to provide such guidance.

The terms used in this chapter conform to standard international usage. The term "source country" is used to denote the country in which income is earned or from which a payment is made, while the term "residence country" is used to describe the country in which the person who earns the income or receives the payment is resident and usually taxable on the income or payment. Developing countries are typically source countries. Moreover, the provisions of bilateral tax treaties based on the United Nations and OECD Model Conventions often require the source country to reduce its taxes on amounts earned in the source country by residents of the residence country.

## **2. Background: the general relationship between tax treaties and domestic law**

The status of tax treaties in a country's legal system may affect how the country applies the provisions of its bilateral tax treaties. The legal status of tax treaties is essentially a question of the relationship between tax treaties, or treaties in general, and domestic law.<sup>4</sup> This topic is well beyond the scope of this chapter. However, it has important consequences for the application of tax treaties in many, if not all, countries. For example, if a country considers treaties (and international law generally) to be the highest source of law in its legal system,

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<sup>4</sup>See, generally, *The Relationship between Tax Treaties and Domestic Law*, Guglielmo Maisto, ed. (Amsterdam: IBFD, 2006).

prevailing over domestic law, it may be unable or reluctant to impose procedural requirements on accessing treaty benefits to the extent that those requirements might be viewed as limiting the treaty benefits. For this reason, a brief discussion of the status of tax treaties in relation to domestic law is provided here as background for the subsequent examination of the issues involved in the practical application of tax treaties.

The first point to emphasize about the status of tax treaties in domestic legal systems is the enormous variation in country practices.<sup>5</sup> In some countries, such as Argentina, Belgium, Italy and the Netherlands, international law and tax treaties are considered to be the highest source of law in the hierarchy of legal rules. This principle may be part of a country's constitution or a creation of the courts. In other countries, such as Australia, Canada, Germany, Norway, Russia and Sri Lanka, tax treaties have the same status as domestic law. In other countries, such as Brazil,<sup>6</sup> the relationship between tax treaties and domestic law is unclear.

Traditionally, under public international law, a distinction was made between so-called monist and dualist approaches to the status of treaties in international law.<sup>7</sup> Under a monist approach, international law and domestic law are part of one system in which international law always prevails over domestic law. Under a dualist approach, international law and domestic law are separate legal systems and the former does not necessarily prevail over the latter in the event of a conflict. Public international law scholars have recognized more recently that this distinction between monist and dualist approaches is too simplistic to accommodate the enormous variation in national practices.<sup>8</sup>

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<sup>5</sup>See, generally, David W. Williams, *Practical issues in the application of double taxation conventions*, General Report, in International Fiscal Association, *Cahiers de droit fiscal international* (Deventer, The Netherlands: Kluwer, 1998), vol. LXXXIIIb, 19-57 at 27-29.

<sup>6</sup>See José Roberto Pisani, "Brazil", in International Fiscal Association, *Cahiers de droit fiscal international*, *supra* note 5, at 270.

<sup>7</sup>See Frank Engelen, *Interpretation of Treaties under International Law* (Amsterdam: IBFD, 2004) at 518-19.

<sup>8</sup>Professor Vogel suggests that the current scholarly term is "moderate dualism." See Klaus Vogel, *Klaus Vogel on Double Taxation Conventions*, 3<sup>rd</sup> ed. (Deventer, The Netherlands: Kluwer, 1997).

The scholarly debate about monism, dualism and moderate dualism is not important for this chapter. What is important, however, for the application of tax treaties is the extent to which a country considers the provisions of tax treaties to prevail over domestic law in the event of a conflict. For countries that consider international law and treaties always to prevail over domestic law, the adoption of domestic rules to implement a treaty will not be allowed to diminish the benefits of the treaty. For some countries, the priority accorded to treaties may be a constitutional requirement, in which case rules for the application of a treaty raise issues of constitutional validity. However, for countries that consider the relationship between treaties and domestic law to be more nuanced, it may be possible to adopt domestic rules that may restrict or qualify access to the benefits of a treaty and, in extreme cases, may deny treaty benefits entirely (so-called treaty overrides). For federal States, the issue may be even more complex because tax treaties may not be legally binding on the subnational governments.

Another significant factor concerning the status of tax treaties is that in some countries they must be incorporated into domestic law in order to have legal effect. Tax treaties are special in this regard. They apply to the contracting States on a State-to-State basis once each State has ratified the treaty. However, in many countries tax treaties do not confer any rights on taxpayers unless they become part of domestic law, which may require additional steps. For example, in several countries tax treaties are incorporated into domestic law by means of legislation that formally declares the treaty to be part of domestic law and gives priority to the provisions of the treaty to the extent that they conflict with domestic law. In some cases the implementing legislation may prescribe procedures or conditions for the application of the treaty. This raises the potential for conflicts between the implementing legislation and the treaty.

Another related issue that may arise is the relationship between the provisions of tax treaties and those of other international agreements, such as trade and investment agreements, that a country may enter into. The issue that arises is which treaty or agreement should prevail in the event of a conflict between them. The general practice of countries, as illustrated by the provisions of the agreement governing the World Trade Organization, is to ensure that tax issues are dealt

with by the tax treaty by carving tax issues out of the trade and investment agreements.

In summary, most countries appear to have considerable freedom and flexibility from the perspectives of both international law and domestic law regarding the method for the application of bilateral tax treaties. Such freedom and flexibility exist despite the widely varying differences with respect to the status of tax treaties vis-à-vis domestic law. Nevertheless, these general considerations concerning the status of tax treaties may impose limitations on the way in which a country applies the provisions of its tax treaties. One especially important aspect of this issue is the relationship between a country's tax treaties and its domestic anti-avoidance rules. This issue is discussed in the final section.

### **3. Rules of application in bilateral tax treaties**

#### **3.1 The United Nations and OECD Model Conventions**

For purposes of both the United Nations and OECD Model Conventions, it is assumed that any rules for the application of the provisions of those Model Conventions are a matter for the domestic law of the contracting States. Consequently, there are no general rules in the Model Conventions or in the Commentaries on how the provisions of the treaty should be applied. There are, however, a few specific rules with respect to application issues that are discussed briefly in this section.

Articles 10 (2) and 11 (2) of both Model Conventions and Article 12 (2) of the United Nations Model Convention, which provide limitations on the rate of source-country tax on dividends, interest and royalties respectively, include the following sentence:

“The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.”

The use of the word “shall” seems to require the competent authorities to agree on the method for the application of the limitations on source-country tax in those Articles. However, the respective

Commentaries indicate that the source country is free to apply its domestic law.<sup>9</sup> In particular, they provide that the source country is entitled to impose its tax by requiring the payer of the dividends, interest or royalties to withhold tax from the payment or by assessing the non-resident recipient of the payment for the tax directly. Not surprisingly, most countries have chosen to collect the taxes on dividends, interest and royalties by way of withholding taxes because this has proven to be an effective mechanism for collecting the tax on these types of payments to non-residents.

The Commentaries also clarify that because procedural issues are not dealt with in the Model Conventions, each country is entitled to adopt its own procedural requirements. Therefore, a country can either limit the rate of tax imposed on the relevant payment to the maximum rate provided in the treaty or it can impose tax on the relevant payment at the rate provided in its domestic law and require the non-resident recipient to apply for a refund of the tax to the extent that it exceeds the rate provided in the treaty.<sup>10</sup> For example, if a country imposes a withholding tax at a rate of 25 per cent on payments

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<sup>9</sup>Paragraph 18 of the Commentary on Article 10 of the OECD Model Convention and paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 18 of the Commentary on Article 10 of the OECD Model Convention; paragraph 12 of the Commentary on Article 11 of the OECD Model Convention and paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 12 of the Commentary on Article 11 of the OECD Model Convention. Although there is no comparable provision in the Commentary on Article 12 (2) of the United Nations Model Convention, it seems likely that a similar result would apply.

<sup>10</sup>Paragraph 19 of the Commentary on Article 10 of the OECD Model Convention and paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 19 of the Commentary on Article 10 of the OECD Model Convention; paragraph 12 of the Commentary on Article 11 of the OECD Model Convention and paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 12 of the Commentary on Article 11 of the OECD Model Convention. Although there is no comparable provision in the Commentary on Article 12 (2) of the United Nations Model Convention, it seems likely that a similar result would apply.

of dividends by a resident company to a shareholder resident in the other contracting State and Article 10 (2) of the treaty between the two countries limits the rate of tax on dividends to 15 per cent, the country can either reduce the obligation on the resident company to withhold tax to 15 per cent of the dividend paid to the non-resident shareholder or require the resident company to withhold tax at the full domestic rate of 25 per cent and require the non-resident shareholder to apply for a refund of the tax withheld in excess of the treaty rate.

The Commentary on Article 1 of the OECD Model Convention reiterates the principle that the contracting States are free to adopt procedures to implement the provisions of the treaty.<sup>11</sup> However, that Commentary expresses a preference for the automatic reduction in the rate of withholding as the more appropriate method for providing the benefits of the treaty—the reduced rate of source-country tax—in an expeditious fashion. That Commentary also emphasizes that, if a country uses a refund mechanism, the refund should be provided expeditiously, unless interest is paid on the amount of the refund.

The provisions of Articles 10 (2) and 11 (2) of both Model Conventions and Article 12 (2) of the United Nations Model Convention, requiring the competent authorities of the contracting States to agree on the method by which the reductions in source country tax are to be applied, are not widely used. The competent authorities are not obligated to agree and most countries have not in fact entered into competent authority agreements as to the mode of application of these provisions.

Aspects of Article 24 (Non-discrimination) of both the United Nations and OECD Model Conventions may affect the method of application of other provisions of the Model Conventions. Article 24 (1) provides that nationals of one country shall not be subject to taxation or “any requirement connected therewith” by the other country that is different or more burdensome than the taxation and connected requirements to which nationals of the other country are subject. A similar requirement applies to stateless persons under Article 24 (2)

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<sup>11</sup>Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention. There is no comparable statement in the Commentary on the United Nations Model Convention.

and to enterprises of one contracting State owned or controlled by residents of the other State under Article 24 (5). The Commentaries indicate clearly that the reference to “any requirement connected” to taxation in Article 24 (1), (2) and (5) is intended to cover procedural aspects related to the application of the provisions of the treaty, such as the filing of tax returns, terms of payment of tax, time and other related requirements.<sup>12</sup> However, the Commentaries on Article 24 (5) of both Model Conventions indicates that most countries do not consider that the imposition of additional information requirements or a reversal of the burden of proof with respect to transfer pricing for enterprises owned or controlled by non-residents would be discriminatory, in violation of Article 24 (5).<sup>13</sup>

The other aspects of Article 24 — the prohibition of discrimination against a permanent establishment in the source country of a resident of the other country under Article 24 (3) and against resident enterprises with respect to the deduction of payments to residents of the other country compared to the deduction of such payments to residents of the source country under Article 24 (4) — do not extend to requirements connected with taxation. Accordingly, a country is not precluded from imposing different requirements concerning the application of the provisions of the treaty to a permanent establishment, as long as the taxation on it is not “less favourable” than the taxation imposed on resident enterprises in similar circumstances. As the Commentaries indicate, under Article 24 (3) “it is the result alone that counts.”<sup>14</sup> Thus, it is permissible for countries to apply a different mode of taxation and related procedural requirements to non-residents

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<sup>12</sup>Paragraph 15 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 15 of the Commentary on Article 24 of the OECD Model Convention.

<sup>13</sup>Paragraph 80 of the Commentary on Article 24 of the OECD Model Convention and paragraph 4 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 80 of the Commentary on Article 24 of the OECD Model Convention.

<sup>14</sup>Paragraph 34 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 34 of the Commentary on Article 24 of the OECD Model Convention.

with permanent establishments. Similarly, although the deduction of payments by a resident of the source country to a resident of the other country must be allowed “under the same conditions” as payments to residents of the source country, Article 24 (4) does not prevent the application to payments to non-residents of different procedural and other related rules, such as additional information requirements.<sup>15</sup>

Article 25 of both the United Nations and OECD Model Conventions provides a mutual agreement procedure whereby the competent authorities of the contracting States can settle “questions relating to the interpretation and application of the Convention”<sup>16</sup> and resolve “difficulties arising out of the application of the Convention in the broadest sense of the term.”<sup>17</sup> These questions and difficulties include procedural aspects of the application of the provisions of the treaty. Article 25 (1) allows a taxpayer to invoke the mutual agreement procedure if “the actions” of a contracting State result — or will result — in taxation that is not in accordance with the provisions of the treaty. According to the Commentaries, the term “actions” has a broad meaning, including “all acts or decisions” relating to the charging of tax.<sup>18</sup> As a result, it appears unlikely that the mutual agreement procedure can be invoked with respect to procedural and other application rules that do not result directly in the charging of tax.

Article 25 (3) of both the United Nations and OECD Model Conventions provides a more general rule that requires the competent authorities to “endeavour to resolve by mutual agreement any difficulties or doubts arising as to the ... application of the Convention.” The

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<sup>15</sup>Paragraph 75 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 75 of the Commentary on Article 24 of the OECD Model Convention.

<sup>16</sup>Paragraph 2 of the Commentary on Article 25 of the United Nations Model Convention.

<sup>17</sup>Paragraph 1 of the Commentary on Article 25 of the OECD Model Convention.

<sup>18</sup>Paragraph 14 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 14 of the Commentary on Article 25 of the OECD Model Convention.

Commentaries indicate that the power of the competent authorities under Article 25 (3) can be used to resolve any problems resulting from the implementation of procedures for the limitation of source-country tax on dividends, interest and royalties.<sup>19</sup> The mutual agreement procedure is discussed in detail in chapter VIII, Dispute resolution: the Mutual Agreement Procedure, by Hugh J. Ault.

Articles 26 and 27 of both the United Nations and OECD Model Conventions, dealing with exchange of information and assistance in the collection of taxes, clearly have an impact on the application of the other provisions of the treaty and on the enforcement of domestic tax generally. Most of the distributive articles of the Model Conventions rely on the need for accurate information about the taxpayers and the income derived by them. Article 26 is an important mechanism to supplement the information-gathering powers of the tax authorities under domestic law. The exchange of information under tax treaties has recently been enhanced through the elimination of bank secrecy, the broadening of Article 26 and the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes.<sup>20</sup> Article 27 is a relatively recent addition to the United Nations and OECD Model Conventions, and thus it has been included in only a few treaties and there is little experience with its practical application. The exchange of information under Article 26 is discussed in detail in chapter IX, Exchange of information, by Diane M. Ring.

### 3.2 Rules of application in actual bilateral tax treaties

Given that the Model Conventions do not contain rules for the application of their provisions, it is not surprising that few individual bilateral

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<sup>19</sup>Paragraph 51 of the Commentary on Article 25 of the OECD Model Convention and paragraph 10 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 51 of the Commentary on Article 25 of the OECD Model Convention.

<sup>20</sup>See OECD, *Global Forum on Transparency and Exchange of Information for Tax Purposes*, at [www.oecd.org/tax/transparency/](http://www.oecd.org/tax/transparency/). The Global Forum was established in 2002 under the auspices of the OECD. As of early 2013, it comprised 120 member countries. The Global Forum has established standards for the exchange of information on request and a peer review process to ensure effective exchanges of information.

tax treaties contain such rules. Italy is an exception in this regard, as it includes a provision in its treaties that requires non-residents to apply for a refund of amounts withheld in excess of the reduced rate provided in the treaty.<sup>21</sup> This provision also makes the time limits of domestic law applicable and requires a certificate from the tax authorities of the residence country that the requirements of the treaty have been satisfied.

## **4. Rules for the application of tax treaties in domestic law**

### **4.1 Introduction**

Given the freedom provided by tax treaties to the contracting States to deal with the methods by which the provisions of tax treaties are applied, it is not surprising that country practices in this regard vary widely. Consequently, it is important for countries, especially developing countries, to be aware of the different methods that are available and to adopt methods that best serve their needs in light of their resources. The development of best practices for the application of tax treaties would be a useful tool for both developing and developed countries.

This section of the chapter raises several issues with respect to the application of tax treaties that countries should deal with in their domestic law. Although it attempts to identify these issues comprehensively, it does not discuss them in detail as most of them are considered in more depth elsewhere in this Handbook. The purpose of this section is to provide a comprehensive framework for thinking about how countries might provide for the application of their tax treaties in their domestic law.

Some countries have no rules in their domestic law with respect to the application of tax treaties. The absence of any application rules is understandable because, when a country first decides to enter into

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<sup>21</sup>Andrea Manganelli, “Italy”, in International Fiscal Association, *Cahiers de droit fiscal international*, supra note 5, 435-54, note 3, at 441-42. However, by Italian ministerial resolution, under certain conditions Italian-resident payers are entitled to apply the reductions in tax directly.

tax treaties with other countries, it is usually preoccupied with developing its negotiating positions on the provisions of either the United Nations or the OECD Model Convention. Countries accept as a general principle that the provisions of any tax treaties that they enter into will take priority over any conflicting provisions of domestic law. As noted above, countries that require some legislative action to incorporate the provisions of tax treaties into domestic law must consider how that will be accomplished. But otherwise, it often appears to be assumed that tax treaty provisions apply more or less automatically, or that any issues concerning their application will be dealt with on a case-by-case basis as they arise.

If a country has rules for the application of tax treaties in its domestic law, several general issues must be considered. First, do those rules apply to all tax treaties or are different rules adopted for different treaties? A second issue is whether any domestic application rules are administrative or legislative in nature. Third, the rules for the application of tax treaties may be dependent on the basic method or methods of taxation — self-assessment, assessment by the tax authorities or withholding tax — adopted by a country. Closely related to, or part of, the method of taxation are the issues of the burden of proof and time limits with respect to claims for treaty benefits. Fourth, several general considerations arise with respect to the role of the country's tax authorities in applying its treaties. For example, the effectiveness and efficiency of domestic rules may be impacted by the location of responsibility for applying tax treaties within the organizational structure of a country's tax authority. Moreover, do the tax authorities have the necessary powers, such as the power to gather information and collect tax, to enable them to apply the provisions of tax treaties effectively? Finally, to what extent do the tax authorities provide administrative guidance to taxpayers concerning the application of tax treaties, and what form does that guidance take?

Each of these general considerations is discussed briefly below.

## **4.2 General or specific application rules**

It may seem obvious, especially for countries with sizeable tax treaty networks, that a country should have general rules to govern the

application of all of its tax treaties. Such general rules would apply uniformly to all treaties and would provide certainty for taxpayers and tax officials. Although the desirability of general rules for the application of tax treaties seems obvious, very few countries have comprehensive general rules.<sup>22</sup> Some countries may consider that rules for the application of tax treaties are unnecessary because the ordinary procedural aspects of their domestic tax law are adequate to deal with any issues.<sup>23</sup>

For many countries, the rules for the application of tax treaties have developed over time on a piecemeal basis in response to specific problems arising with respect to a specific treaty or a specific article. In some cases, application of the rules may have emerged from case law rather than legislation. Such a system of specific rules may lack coherence and consistency. More importantly, the complexity of such a system may result in the denial of treaty benefits if those benefits are conditional on a taxpayer's faithful adherence to the application rules. Because of these problems, it would be worthwhile for countries entering into tax treaties to seriously consider promulgating general rules (legislative or administrative – see section 4.3 below) for the application of tax treaties. Such general rules should deal with issues such as the requirements for claiming treaty benefits (filing tax returns or other forms, information disclosure requirements, burden of proof, time limits, etc.).

Moreover, the promulgation of general rules for the application of tax treaties could require a country to apply all of its tax treaties uniformly. Such uniformity would ensure that taxpayers are treated fairly in terms of access to treaty benefits irrespective of the particular tax treaty that applies. However, this type of equal treatment might be viewed as inappropriate in some circumstances. Tax treaties are bilateral rather than multilateral agreements and therefore differences between a country's tax treaties are to be expected. In some cases, the particular treaty negotiated between two countries may involve not only the substantive provisions of the treaties but also the method of application for those provisions. Therefore, the only firm conclusion

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<sup>22</sup>Williams, *supra* note 5, at 32-35.

<sup>23</sup>This is apparently the situation in Belgium. See Thierry Denayer, "Belgium", in International Fiscal Association, *Cahiers de droit fiscal international*, *supra* note 5, 245-64 at 245-46.

concerning the equal application of a country's tax treaties is that, in principle, it is a desirable objective, although it may be subject to exceptions based on particular treaties.

### **4.3 Legislative or administrative rules**

Country practices vary concerning the use of legislative or administrative rules, or a combination of both, to deal with the application of tax treaties. What type of law is used to deal with the application of tax treaties is a question of domestic law. In some countries, issues concerning the application of tax treaties are treated as matters of general administrative law. In other countries they are matters for tax law.<sup>24</sup> Further, there is the additional question of whether application rules should be the subject of binding rules of law or non-binding administrative pronouncements from the tax authorities. There are advantages and disadvantages associated with each approach. For example, the use of binding rules provides more certainty for taxpayers and tax officials but the use of administrative guidance may provide more flexibility, as such guidance can usually be more easily revised to reflect changing circumstances.

### **4.4 Relationship between the rules for the application of tax treaties and the method of taxation**

In general, there are three primary methods used by countries to establish the amount of tax payable by a person: assessment by the tax authorities, self-assessment and withholding. Under a system that requires the tax authorities to assess the amount of tax payable, the taxpayer is typically obligated to provide certain specified information and the tax authority is obligated to assess the tax payable based on that information. In contrast, under a self-assessment system, the taxpayer is obligated to file a return containing specified information and to determine the amount of tax payable. Under a withholding tax (which must be distinguished from a system of interim withholding

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<sup>24</sup>The character of the rules for the application of tax treaties may have implications for the resolution of tax disputes concerning those rules. Such disputes may be subject to the jurisdiction of the administrative courts or specialized tax courts.

on account of tax payable), the payer of certain amounts is obligated to withhold the amount of tax imposed, usually at a flat rate on the gross amount paid, and remit such tax to the tax authorities. As a general matter, countries appear to use a combination of withholding taxes on certain payments to non-residents together with either self-assessment or assessment by the tax authorities for other amounts.

The method of taxation can have an important effect on how the provisions of tax treaties are applied. Under a system of assessment by the tax authorities, the responsibility for applying the provisions of a tax treaty rests with the tax authorities in the same way that they must apply other aspects of the tax law. Nevertheless, some countries require taxpayers to make a specific request for treaty benefits and provide the information necessary to support the claim. This type of requirement makes good sense for practical reasons. Taxpayers are in a much better position than the tax authorities to know which treaty, and which provisions of it, are relevant.

If taxpayers are not required to make specific requests for treaty benefits, the tax authorities will be required to analyse the information provided by the taxpayer and thereafter determine whether the provisions of a tax treaty are applicable. The administrative burden imposed on the tax authorities in this regard may be onerous, depending on the size of the country's tax treaty network, the quality of the information provided by the taxpayer and the sophistication and experience of the tax authorities with respect to tax treaties. Apart from the administrative issues, requiring taxpayers to make specific requests for treaty benefits raises the question of the consequences if a request for treaty benefits is not made in the proper manner or within the time limit established for filing the request. It is arguably inappropriate, and perhaps a violation of the treaty, to deny the benefits of the treaty because of a failure to comply with procedural requirements of domestic law.

Under a self-assessment system, the onus is on the taxpayer to claim any treaty benefits that may be applicable. The taxpayer applies the relevant provisions of a treaty in the first instance — usually when filing a tax return — and the tax authorities then have the responsibility to verify the taxpayer's claim. Even under a self-assessment system, some countries require taxpayers to disclose specifically any claims

for exemptions, credits or reduced rates of tax based on tax treaties.<sup>25</sup> The same effect may be accomplished in countries (for example, Australia)<sup>26</sup> that impose penalties for failure to disclose questionable positions that turn out to be incorrect. Some countries may deny self-assessment to non-residents making claims for treaty benefits because of concerns about protecting the domestic tax base. However, this concern is limited to business profits because most countries enforce taxes on payments to non-residents by withholding, as discussed below.

Claiming treaty benefits under a self-assessment system raises a serious concern where a taxpayer claims exemption from source country tax as a result of the treaty. For example, a resident enterprise of one country doing business in the other country claims that it is not taxable in the other country because it is not carrying on business through a permanent establishment in the other country. The issue raised by this situation is whether the enterprise is required to file a tax return in the other country even though it claims to be exempt from tax by that country. If the taxpayer is not required to file a return, the tax authorities of the source country may never get notice about the taxpayer's situation and never get an opportunity to verify the taxpayer's claim for exemption. Therefore, in such circumstances, it is appropriate to require taxpayers to file a return or otherwise disclose the claim for exemption.<sup>27</sup>

The importance of disclosing exemptions claimed under tax treaties also applies to residents of a country claiming an exemption or reduction in residence country tax as a result of the application of a tax treaty. For example, under the provisions of the tax treaty, a taxpayer may claim exemption from residence country tax under Article 23 for

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<sup>25</sup>For example, section 6114 of the United States Internal Revenue Code requires taxpayers to disclose if they are claiming treaty benefits.

<sup>26</sup>See Roger Hamilton, "Australia", in International Fiscal Association, *Cahiers de droit fiscal international*, supra note 5, 217-23 at 217. Under this type of penalty regime, taxpayers are induced to disclose any tax positions, including tax treaty positions, which are risky.

<sup>27</sup>Such a requirement would not be discriminatory under Article 24 (3), even if it is imposed only on non-residents claiming exemption, because this provision does not extend to requirements connected with taxation, as discussed above in section 3.1.

income that is taxable in the source country. The taxpayer should be required to disclose the claim for exemption so that the tax authorities can verify that claim. Moreover, although the residence country exempts the foreign source income from residence country tax, it may take that income into account in determining the rate of tax on the taxpayer's other income (exemption with progression) or for other purposes. In this case, the residence country requires information concerning the amount of the income earned in the source country.

Many countries use withholding at source as an effective means of collecting tax. In some cases (for example, salaries of the employees) the withholding may be imposed on an interim basis. After the end of the year, taxpayers are required to pay any tax deficiency or claim a refund for any excessive tax withheld for the year. In other cases, often involving payments of dividends, interest, rent and royalties to non-residents, the amount withheld is imposed as a final tax without the possibility of any further payment or refund. In either case, the obligation to withhold is imposed on the payer of the amount. In most cases, the payer will be a resident of the country or a non-resident with a permanent establishment in the country. The provisions of tax treaties do not deal with withholding per se. Consequently, the application of withholding as an interim measure or as a withholding tax is a matter for domestic law. Thus, even if a treaty provides for a maximum tax rate of 15 per cent on the amount of a dividend paid by a resident company to a shareholder resident in the other country, the domestic law may require the company to withhold at a higher rate or a lower rate, or it may exempt the payment from residence country tax completely. If the country requires withholding at a rate higher than the rate of tax specified in the treaty, it must provide a refund of the excess tax withheld. In this case, the non-resident is usually required to file a claim for a refund, which the tax authorities have an opportunity to verify.

Many countries align the obligation to withhold imposed on a resident payer and the rate of taxation specified in the treaty. In this situation, the obligation to apply the provisions of the treaty is imposed, in the first instance, on the withholding agent. If the withholding agent fails to withhold the required amount, it is often made liable to pay that amount as tax on behalf of the non-resident. Again, the issue is: how do the tax authorities get notice that the amount of

withholding has been reduced pursuant to the provisions of a tax treaty so that they have an opportunity to verify that the claim for reduced tax is legitimate? As mentioned above, this concern must be balanced against the interest of taxpayers receiving the benefits of reduced withholding taxes under tax treaties in a timely manner.

## **4.5 The role of the tax authorities in applying tax treaties**

### **4.5.1 Introduction**

Since the provisions of tax treaties require interpretation and application, the role of tax authorities of a country in performing these functions is important. In this section, three aspects of the role of the tax authorities with respect to applying tax treaties are discussed: the location of responsibility for applying tax treaties; the powers of the tax authorities relating to the application of tax treaties; and administrative guidance for taxpayers concerning the application of tax treaties.

As a general matter, the development of expertise by the tax authorities with respect to tax treaties is a critical prerequisite for their proper application. Such expertise is relatively scarce, even in the tax administrations of developed countries with extensive and longstanding treaty networks. The development of such expertise in the tax administrations of developing countries is a serious challenge.

### **4.5.2 Location of responsibility for applying tax treaties**

One important aspect of how the tax authorities of a country apply the provisions of tax treaties is where the responsibility for that function is located in the organizational structure of the tax administration. There are many possibilities in this regard and although no single option is right for all countries, it is a matter that all countries should consider seriously. Some of the considerations that should be taken into account include:

- Whether issues involving the application of tax treaties are dealt with by a centralized unit of tax treaty specialists or by decentralized tax auditors as part of their general assessment and audit functions. If the responsibility for tax treaties is

decentralized, there should be some mechanism for ensuring co-ordination between the decentralized units. If the responsibility for tax treaties is centralized, it is important for the local auditors to be able to identify tax treaty issues so that they can be referred to the central unit responsible for tax treaties.

- How the tax administration is organized to deal with international issues in general. The provisions of tax treaties affect both residents of a country earning foreign source income and non-residents earning domestic source income. Therefore, if a country allocates responsibility for dealing with residents earning foreign source income and non-residents earning domestic source income to different units, responsibility for applying tax treaties could be allocated on the same basis. However, for many developing countries, the taxation of non-residents earning domestic source income is likely to be more important than the taxation of residents on their foreign source income.
- If responsibility for applying tax treaties is allocated to different groups or units within the tax administration, their work should be coordinated to avoid duplication and inconsistency.
- The relationship between the competent-authority function and the application of tax treaties to taxpayers.

#### **4.5.3 The powers of the tax authorities relating to the application of tax treaties**

The tax authorities must have the powers to properly investigate claims for treaty benefits. These powers include the ability to gather information and to collect tax. These powers are not peculiar to tax treaties and a detailed discussion is beyond the scope of this overview.

The power to obtain information from a country's treaty partners is particularly important for the verification of claims for treaty benefits. Article 26 of both the United Nations and OECD Model Conventions provides for the exchange of information necessary to carry out the terms of the treaty.<sup>28</sup> In addition, as noted above, Article 27 of both the United Nations and OECD Model Conventions

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<sup>28</sup>See chapter IX, Exchange of information, by Diane M. Ring.

allows the treaty partners to provide assistance in the collection of each other's taxes.

#### **4.5.4 Administrative guidance for taxpayers concerning the application of tax treaties**

It is obviously important for the tax authorities to provide as much information as possible to taxpayers on how the provisions of the country's tax treaties will be applied. At the very least, the tax authorities should provide the text of the tax treaties that the country has entered into with other countries, preferably in electronic format freely accessible to taxpayers and their advisers. Other information that could be provided includes treaties signed, but not yet ratified, and an up-to-date list of countries with which negotiations for a tax treaty have commenced. The provision of this type of basic information is especially important for developing countries in which such information may not be readily available from commercial publishers.

In addition, the tax authorities should provide information about any procedures that must be followed, or forms that must be filed to obtain treaty benefits, including any related time requirements. It is desirable that such information be provided in a readily accessible manner on the tax authorities' websites. Treaty benefits should not be denied because taxpayers cannot easily discover and comply with any procedural requirements. Similarly, any forms should also be readily available on those websites.

The use of forms is a common and effective way used by several countries to allow taxpayers to claim treaty benefits. To the extent that such forms may impose procedural requirements, however, they may make treaty benefits more difficult to obtain, contrary to the purpose of the treaty. For example, if a non-resident is expected to file a form claiming reduced treaty rates of withholding tax for every such payment, the compliance burden on the taxpayer and the administrative burden on the tax authorities dealing with the forms could be substantial. In some circumstances, the taxpayer may be required to file the forms with the withholding agent rather than with the tax authorities. The withholding agent is then required to file a return with the tax authorities. If forms are used, a decision must be made as to whether their use is mandatory or optional and, if optional, whether a letter

providing the necessary information is sufficient. Obviously, it is desirable if the forms are available in the languages of the country's treaty partners.

Many tax authorities provide binding rulings to taxpayers with respect to proposed transactions. These advance rulings should also be available with respect to the application of tax treaties. In addition, taxpayers should be able to contact the tax authorities to discuss potential claims for treaty benefits on an informal and impartial basis. Such informal contact assumes that the tax authorities responsible for the application of tax treaties are identifiable and that they have the necessary expertise to provide meaningful guidance to taxpayers. It goes without saying that the tax authorities should provide equal access to all taxpayers and their professional advisers.

## **5. Persons entitled to the benefits of tax treaties**

### **5.1 Introduction**

This section deals with the necessity for the tax authorities to determine whether a person is entitled to the benefits of a particular tax treaty. This topic is dealt with in more detail in chapter II, Persons qualifying for treaty benefits, by Johanna Wheeler.

According to Article 1 of both the United Nations and OECD Model Conventions, those Conventions apply to persons who are residents of one or both of the contracting States. Therefore, before applying the provisions of a treaty, it is necessary for the tax authorities to determine if the person claiming the benefits of the treaty is entitled to them as a resident of one of the contracting States. The determination of residence for purposes of the treaty must be made by a country with respect to its own residents and the residents of the other contracting State. Further, for Articles 10, 11 and 12 of both Model Conventions, it is necessary for the recipient of dividends, interest or royalties to be the beneficial owner of the payment in order to obtain the benefit of the reduced rates of source-country tax provided by the treaty. The determination of residence, beneficial ownership and connected requirements is discussed in this section. The application of the substantive

provisions of a tax treaty to residents of a country, and to residents of the other country, is then discussed in sections 6 and 7 below.

Time limits for claiming the benefits of a treaty cause many difficulties, especially where the domestic rules of the contracting States differ significantly. One persistent problem is the need for a taxpayer to provide information to one country before the information is available because, for example, it depends on the tax situation in the other country. Time limits are also relevant with respect to the period during which the tax authorities may reopen a matter.

## 5.2 Identification of persons

As noted above, only persons who are residents of one or both contracting States qualify for the benefits of the treaty. Accordingly, the first requirement is that there must be a person. Article 3 (1) (a) of both Model Conventions defines a person to include “an individual, a company and any other body of persons.” A company is defined in Article 3 (1) (b) to mean “any body corporate or any entity that is treated as a body corporate for tax purposes.” The terms “individual,” “body of persons,” “body corporate” and “entity” are not defined. The Commentary on Article 3 of the United Nations Model Convention indicates that the term person “should be interpreted very broadly.”<sup>29</sup> Similarly, the Commentary on Article 3 of the OECD Model Convention indicates that the term “person” is used in a very wide sense. Both Commentaries indicate that partnerships are considered to be persons, either as companies or as bodies of persons.

Because of the broad definition of “person,” it will be clear, in most cases, that the claimant is a person. In any cases where there is doubt, the country applying the treaty should apply the provisions of its own law in accordance with Article 3 (2) of the treaty to determine if there is a person and the nature of the person (that is to say, individual, company, etc.). A question whether a person exists for purposes of a treaty could arise with respect to the special entities discussed below.

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<sup>29</sup>Paragraph 4 of the Commentary on Article 3 of the United Nations Model Convention.

### 5.3 The determination of residence

Only a resident of a contracting State is entitled to treaty benefits. Under Article 4 of both Model Conventions, a resident of a contracting State is defined to be a person who is liable to tax in that State by reason of certain criteria. Therefore, as a preliminary matter, it must be determined whether a person is a resident of a country so that he can claim the benefits of that country's treaties.

Where a country must determine whether a person is a resident of that country for purposes of its tax treaties,<sup>30</sup> the determination of residence is straightforward. In the first instance, it must be determined whether the person is a resident under the country's domestic law. This issue should not be difficult for either the taxpayer or the tax authorities, as they both can be expected to be familiar with their own domestic law. Similarly, in most cases, it should be straightforward to determine whether the person is a resident under the definition in Article 4, because again the issue is whether the person is liable to tax under domestic law by reason of certain criteria. In effect, the country applies its own domestic law to determine whether a person is resident in the country under Article 4.

In some countries, there may be a direct link between an individual's immigration status and their tax status as a resident. The United States of America Green Card is the best-known example. Anyone holding a Green Card, which allows the person to enter the United States to work, is considered to be a resident for United States tax purposes. Such a direct link between immigration status and residence may induce taxpayers to comply with their tax obligations as residents in order to maintain their immigration status.

Where, however, a country must determine whether a person is a resident of the other contracting State,<sup>31</sup> the issue is much more difficult. In this situation, the tax authorities must determine if the person is a resident of the other contracting State for purposes of the

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<sup>30</sup>This is necessary primarily for the relief from double taxation under Article 23. See section 6 below.

<sup>31</sup>This is necessary to apply the benefits under the distributive articles (Articles 6-21) of the treaty.

treaty by applying the other State's domestic law. Not surprisingly, many countries require a certificate from the tax authorities of the other country to the effect that the person is a resident of that country as a condition for granting the benefits of the treaty. The use of residence certificates is widespread and can be formalized by an agreement between the competent authorities, as provided for in Articles 10 (2), 11 (2) and 12 (2) (United Nations Model Convention only). The efficiency of the use of residence certificates can be improved if special forms for the purpose are created in the relevant languages of the two countries. The taxpayer can obtain a certificate from its country of residence and provide it to the country from which treaty benefits are claimed. Alternatively, the tax authorities of the country of residence can send the form directly to the tax authorities of the source country.

A country may require the tax authorities of the other country to certify things in addition to residence. For example, a country may require the foreign tax authorities to certify that the taxpayer is the beneficial owner of dividends, interest or royalties in order to get the benefit of the reduced rates of source-country tax under Articles 10 (2), 11 (2) and 12 (2) (United Nations Model Convention only).

There are potential problems with the requirement of residence and other certifications from the tax authorities of the other countries. Although the requirement of a certificate of residence imposes some additional compliance burden on the taxpayer and an administrative burden on the tax authorities, this burden does not seem overly onerous if it is simply an annual requirement. If, however, a separate certificate is required for each payment, the burden could be significant. Another problem is the potential delay in obtaining the benefits of the treaty caused by the necessity to obtain residence or other certifications from the foreign tax authorities. The delay is dependent on how frequently such certificates are required and how much information about the tax affairs of the taxpayer must be certified by the foreign tax authorities. Another potential problem is the possible use of the certificate as leverage against the taxpayer in its other unrelated dealings with the tax authorities. Such misuse of the certification process should be discouraged. Residence and other certificates should be issued by the tax authorities based exclusively on the merits of each certificate requested.

Some countries allow withholding agents to reduce the amount withheld pursuant to a treaty based on the address of the recipient. Relying on addresses in this way makes the delivery of treaty benefits much more efficient, but is susceptible to abuse. Therefore, the withholding agent may not be able to rely on the recipient's address if the agent has reason to suspect that the recipient is not a resident of the other contracting State. In this case, a residence certificate must be obtained.

Situations in which a taxpayer is considered to be resident in both contracting States for purposes of a tax treaty are frequently encountered because countries' residence rules tend to be overly broad. In these dual-resident cases, the United Nations and OECD Model Conventions provide tie-breaker rules to allocate residence exclusively to one contracting State for purposes of the treaty. Under Article 4 (2) of both Model Conventions, a hierarchy of four tie-breaker rules is provided for individuals, whereas under Article 4 (3) the tie-breaker rule for other persons is the person's place of effective management. The Commentaries on both Model Conventions allow countries to resolve the dual residence of entities other than individuals on a case-by-case basis pursuant to the mutual agreement procedure instead of by reference to the entity's place of effective management.

The application of the tie-breaker rules has important implications for the contracting States because it determines which country must give up its taxing rights. Consequently, the application of the tie-breaker rules should be carefully considered. For individuals, the tie-breaker rules are intensely factual and should be applied on a balanced basis to give residence to the country to which the individual is more closely connected. In addition, dual-resident entities are sometimes used for tax avoidance purposes.<sup>32</sup>

## **5.4 Hybrid and special entities**

The application of the definition of resident of a contracting State to persons other than individuals and companies creates special problems. For example, although a partnership is a person for purposes of

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<sup>32</sup>See section 8 below.

a tax treaty,<sup>33</sup> it is not a resident of a country under Article 4 (1) if it is not liable to tax under the laws of that country. In many countries, partnerships are treated as flow-through or transparent entities for income tax purposes. They are not taxable but the partners are taxable on their shares of the partnership's income. In other countries, at least some partnerships may be taxable on their income in the same way as corporations. Similar issues may arise with respect to trusts, foundations and other entities.

A partnership that is treated by one contracting State as a flow-through or transparent entity, but by the other contracting State as a separate taxable entity and a resident, is an example of a so-called hybrid entity. These hybrid entities cause serious problems for the application of tax treaties. For example, in some cases, their use may result in unrelieved double taxation. For example, assume that X, a resident of Country A, earns business profits sourced in Country B through a limited liability company (LLC) established under the laws of Country B. Country B treats the LLC as a separate entity for tax purposes. Therefore, Country B imposes tax on the LLC as a resident of Country B. In contrast, Country A treats the LLC as a flow-through or transparent entity for tax purposes and imposes tax on X in respect of the income earned through the LLC. However, Country A may not allow any credit under Article 23 for the tax paid to Country B on the income because the tax is paid by the LLC, not by X. This type of double taxation is contrary to the spirit of the treaty.

In other cases, the use of a hybrid entity can result in double non-taxation. For example, assume that an LLC established under the laws of Country B realizes a capital gain in respect of shares of a corporation resident in Country B. Country B does not tax the LLC on the gain because it treats the LLC as a flow-through or transparent entity for income tax purposes. Instead, Country B considers the capital gain to have been realized by the members of the LLC, who are all individuals resident in Country A. Therefore, under Article 13 of the treaty between Countries A and B, Country B does not have the authority to tax the capital gain (assuming that the assets of the LLC do not consist primarily of immovable property located in Country B). On the other hand, Country A considers the LLC to be a separate taxable entity and,

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<sup>33</sup>Because it is a body corporate or a body of persons under Article 3 (1).

therefore, it does not tax the capital gain because it belongs to a resident of Country B. The use of hybrid entities to obtain tax treaty benefits raises the possible application of anti-avoidance rules. The prevention of tax avoidance through the use of tax treaties is discussed below in the final section of this chapter and in chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Phillip Baker.

The Commentaries on both the United Nations and OECD Model Conventions provide useful guidance concerning the application of the provisions of a treaty to partnerships and their partners,<sup>34</sup> real estate investment trusts and collective investment vehicles.<sup>35</sup> However, they do not provide any similar guidance regarding trusts and other entities or on the treatment of hybrid entities generally.

## 5.5 Beneficial owner

The benefit of the reduced rate of source-country tax on dividends, interest and royalties under Articles 10, 11 and 12 is available only if the recipient of the payment is a resident of the other contracting State and the beneficial owner of the payment. Therefore, the application of Articles 10, 11 and 12 requires a source country to determine if this is the case. According to the Commentaries, the use of the term “beneficial owner” in Articles 10, 11 and 12 is intended to deny the reduced rates of source-country tax where the payments are received by an agent, nominee or conduit and the real owner of the payment is not

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<sup>34</sup>The primary references to partnerships and their partners are found in paragraphs 2-6.7 of the Commentary on Article 1 of the OECD Model Convention and paragraphs 4-7 of the Commentary on Article 1 of the United Nations Model Convention; paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention and paragraph 6 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention; and paragraphs 6.1 and 6.2 of the Commentary on Article 15 of the OECD Model Convention and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 6.1 and 6.2 of the Commentary on Article 15 of the OECD Model Convention.

<sup>35</sup>Paragraphs 6.8-6.34 of the Commentary on Article 1 of the OECD Model Convention and paragraphs 67.1-67.7 of the Commentary on Article 10 of the OECD Model Convention.

a resident. The precise meaning of “beneficial owner,” especially as it applies to conduits, is unclear.

The OECD has recently proposed to clarify it.<sup>36</sup> In October 2012, the OECD issued revised proposals to amend the Commentaries on Articles 10, 11 and 12 to provide that beneficial owner has a treaty meaning independent of domestic law<sup>37</sup> and that it means “the right to use and enjoy” the amount “unconstrained by a contractual or legal obligation to pass on the payment received to another person.”<sup>38</sup> However, the Commentaries will retain comments that the concept of beneficial owner is an anti-avoidance rule and must be determined “in substance.”

The application of the beneficial-owner concept by the tax authorities presents some problems. The purpose of the concept is to ensure that treaty benefits are provided only to the real owners of the relevant payments. The concept is closely related to the requirement that the recipient of the payment must be a resident of the other country, as discussed above, and to anti-avoidance rules to prevent abuse of tax treaties (the so-called anti-treaty-shopping rules). Thus, the beneficial-owner concept should be applied taking this context into account.

In addition, it is not completely clear where the tax authorities should look for the source of the meaning of the term beneficial owner. Presumably, the Commentary on the OECD Model Convention will be revised in 2014 to indicate that the term has a treaty meaning independent of the domestic law of the contracting States. However, the proposed OECD Commentary does not provide a meaning that is completely clear. Currently, some countries determine the meaning of beneficial owner under their domestic law, in accordance with Article 3 (2). Other countries may consider it appropriate to determine

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<sup>36</sup>See *OECD Model Tax Convention: Revised Proposals concerning the Meaning of “Beneficial Owner” in Articles 10, 11, and 12, October 19, 2012*, available at [www.oecd.org/ctp/treaties/Beneficialownership.pdf](http://www.oecd.org/ctp/treaties/Beneficialownership.pdf).

<sup>37</sup>*Ibid.* Proposed paragraph 12.1 of the Commentary on Article 10, paragraph 9.1 of the Commentary on Article 11, and paragraph 4 of the Commentary on Article 12.

<sup>38</sup>*Ibid.* Proposed paragraph 12.4 of the Commentary on Article 10, paragraph 10.2 of the Commentary on Article 11, and paragraph 4.3 of the Commentary on Article 12.

the meaning under the domestic law of the residence country because it is so closely related to the concept of residence as determined under the law of the residence country, in accordance with Article 4. If so, it would be appropriate for these countries to require taxpayers to obtain a certificate from the foreign tax authorities that they are both residents and beneficial owners for purposes of the foreign law.

## **6. The application of tax treaties by a country to its own residents**

### **6.1 Introduction**

In general, the provisions of tax treaties do not restrict a country's authority to tax its own residents. The provisions of tax treaties, however, do affect the taxation of a country's residents, most importantly with respect to relief from double taxation and the prohibition of discrimination.<sup>39</sup> The application of Article 24 (4) and (5), dealing with discrimination against resident enterprises that are owned or controlled by non-residents or that pay amounts to residents of the other contracting State, is dealt with in section 3.1 above. Typically, claims for relief from discrimination would be made by a resident in filing its tax return or making a specific request to the tax authorities. Therefore, this section focuses on relief from double taxation.

Before determining whether a taxpayer is entitled to relief from international double taxation under an applicable tax treaty, the tax authorities of a country must determine that the taxpayer is a resident of the country. The determination of residence is dealt with in section 5.3 above.

### **6.2 Relief from double taxation**

#### **6.2.1 Introduction**

The provisions of the United Nations and OECD Model Conventions eliminate double taxation in a variety of ways depending on the type of

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<sup>39</sup>See chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

income. With respect to some items of income, exclusive taxing rights are given to the residence country. For example, this is the case for royalties under Article 12 of the OECD Model Convention, for business profits where the taxpayer does not have a permanent establishment in the source country, and for certain capital gains. For certain other limited types of income, for example, income from government service under Article 19, the source country is given exclusive taxing rights. In these situations, double taxation cannot arise because only one country is entitled to tax. However, for many items of income dealt with under the distributive articles of the treaty, both the source and residence countries are entitled to tax. In these circumstances, under Article 23 of both the United Nations and OECD Model Conventions, the residence country is obligated to provide relief from double taxation with respect to any income that is properly subject to tax in the source country in accordance with the treaty. Article 23 requires relief to be provided by means of either an exemption of the relevant income from residence-country tax or a credit against residence-country tax for the tax paid to the source country on the relevant income. The general issues involved in applying the provisions of Article 23, under both the exemption and foreign tax credit methods, are discussed below.

Before dealing with the exemption and credit methods for relieving double taxation, it is important to understand the relationship between a country's domestic law with respect to double tax relief and the provisions of an applicable tax treaty. If a country's domestic law provides more generous relief than is provided in the tax treaty, in general the taxpayer will be entitled to the more generous relief under domestic law because tax treaties are generally considered to be relieving in nature. If, however, more generous relief is provided in the tax treaty, the taxpayer will be entitled to that relief because tax treaties prevail over domestic law. These points seem reasonably clear. The more difficult issue is that the rules of Article 23 are broad and general. In contrast, often the rules of domestic law dealing with double taxation relief, especially the foreign tax credit, are quite detailed. Consequently, the provision of relief under the treaty may necessitate the application of aspects of domestic law. The issue is whether the application of domestic rules in this regard is legitimate if it limits the relief under the treaty.

The Commentaries on Article 23 of both the United Nations and OECD Model Conventions indicate that the provisions of both Articles 23 A and 23 B “do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic law and practice applicable.”<sup>40</sup> Because of the intimate relationship between Article 23 and the provisions of domestic law providing relief from double taxation, some countries limit the relief provided under Article 23 of the treaty to the relief provided in domestic law.<sup>41</sup>

Most countries use both the exemption method and the credit method for relieving double taxation. Often the exemption method is restricted to business profits earned in the other country, while the credit method is used for other types of income. This type of mixed approach is expressly recognized by Article 23 B (2) of both Model Conventions.

It should also be noted that the competent authorities are authorized by Article 25 (3) to use the mutual agreement procedure to consult about the elimination of double taxation that is not eliminated under Article 23 or the other provisions of the treaty.

### **6.2.2 Exemption method**

Although the exemption method appears to be simple, it raises several issues. The major difference between the exemption method and the credit method in terms of the application of the treaty provisions is that the amount of tax paid to the source country is irrelevant under the exemption method. The tax authorities of the residence country do not require any information from the taxpayer or the tax authorities of the source country about the amount of tax paid in the source country. However, the residence country often needs information

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<sup>40</sup>Paragraph 32 of the Commentary on Article 23 of the OECD Model Convention and paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 32 of the Commentary on Article 23 of the OECD Model Convention.

<sup>41</sup>See paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention and paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention.

about the amount of income earned in or received from the source country in order to determine the amount to be exempted, the tax rate on other income (exemption with progression, which is expressly authorized by Article 23 A (3)), and the thresholds based on income. The Commentaries on both the United Nations and OECD Model Conventions indicate that many problems can potentially arise concerning the application of the exemption method under Article 23 A.<sup>42</sup> Because Article 23 A is silent about these problems, the provisions of domestic law apply. However, recourse to domestic law is not helpful if the exemption method is not used under domestic law. In such situations, the Commentaries suggest that the contracting States should adopt rules for the application of the exemption method pursuant to the mutual agreement procedure.

Countries should be especially sensitive to the possibility of double non-taxation where the exemption method is used. The Commentaries recognize that countries may agree to amend Article 23 to prevent such double non-taxation.<sup>43</sup> Moreover, Article 23 itself permits countries that ordinarily use the exemption method to use the credit method for dividends, interest and other income items.<sup>44</sup> More generally, the problem of double non-taxation involves the larger issue of the abuse of tax treaties and the relationship between tax treaties and domestic anti-abuse rules, which are discussed in section 8 below.

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<sup>42</sup>Paragraphs 38-46 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 38-46 of the Commentary on Article 23 of the OECD Model Convention.

<sup>43</sup>For example, by agreeing to limit the exemption method to income that is effectively taxed in the source country. Paragraph 35 of the Commentary on Article 23 of the OECD Model Convention, paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 35 of the Commentary on Article 23 of the OECD Model Convention, paragraph 15 of the Commentary on Article 23 of the United Nations Model Convention and paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>44</sup>Paragraph 31 of the Commentary on Article 23 of the OECD Model Convention and paragraph 15 of the Commentary on Article 23 of the United Nations Model Convention.

A final point about the application of the exemption method under Article 23 relates to the treatment of losses incurred in the source country by a resident of the other contracting State. Some residence countries may deny any deduction of such a loss because any income from the source country is exempt. In such a case, relief for the loss must be provided by the source country in the form of a loss carryover. If, however, the residence country allows a deduction for a loss occurring in the source country, the residence country is free to reduce the exemption for income subsequently derived from the source country by the amount of the earlier loss.<sup>45</sup> This point about losses is important because it emphasizes the more general point that the proper application of the provisions of the treaty often involves the interaction between the treaty and the country's domestic law.

### **6.2.3 Credit method**

As with the exemption method under Article 23 A, the provisions of Article 23 B with respect to the credit method do not contain detailed rules for the application of the credit method. Therefore, similar problems of application arise under the credit method as under the exemption method. These problems are sometimes resolved by recourse to the domestic law of the residence country relating to the foreign tax credit. However, if that country does not provide a foreign tax credit under its domestic law, according to the Commentaries, it should establish rules of application for the credit under Article 23 B and it should, if necessary, consult with the competent authority of the source country.<sup>46</sup>

Many issues arise in connection with the computation of a foreign tax credit: differences in the timing of the recognition of the income in the source and residence countries, foreign exchange issues,

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<sup>45</sup>Paragraph 44 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 44 of the Commentary on Article 23 of the OECD Model Convention.

<sup>46</sup>Paragraph 60 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 60 of the Commentary on Article 23 of the OECD Model Convention.

the determination of the limitation of the credit to the portion of the domestic tax attributable to the income earned in the source country, the treatment of losses, and hybrid entities.<sup>47</sup> The Commentaries on both the United Nations and OECD Model Conventions indicate that these “problems depend very much on domestic law and practice, and the solution must, therefore, be left to each State.”<sup>48</sup>

Where a country uses the credit method under Article 23 B, the deduction allowed against its tax is based on the tax paid to the other contracting State. Most countries require taxpayers to provide proof concerning the amount of foreign tax paid by presenting a copy of the foreign tax return and evidence that the foreign tax has been paid. A certificate from the foreign tax authorities could be required for this purpose.

Although the United Nations and OECD Model Conventions do not contain such provisions, many tax treaties between developed and developing countries have “tax sparing” provisions. The purpose of these provisions is to ensure that tax incentives provided by developing countries for non-resident investors go to those investors rather than to the government of the country in which they are resident. If the residence country uses the credit method, then any tax incentives provided by the source country for investors resident in the residence country will be effectively cancelled by the tax imposed by the residence country.

For example, assume that a corporation resident in Country A makes a large investment in developing a new mine in Country B. To attract these types of new investments, Country B provides a three-year tax holiday for the profits from the mine once it commences production. As a result, the profits are exempt from Country B’s

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<sup>47</sup>Paragraphs 61-65 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 61-65 of the Commentary on Article 23 of the OECD Model Convention.

<sup>48</sup>Paragraph 66 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 66 of the Commentary on Article 23 of the OECD Model Convention.

ordinary corporate income tax, which is imposed at a rate of 30 per cent. Assuming that the corporation earns profits of one million in the first year of the operation of the mine, the corporation will pay no tax in Country B. However, assuming Country A taxes its residents on their worldwide income at a rate of 35 per cent, the corporation will pay tax to Country A on its profits from Country B of 350,000. If Country B did not provide any tax holiday, it would have imposed a tax of 300,000 and the corporation would have been entitled to claim a credit for the Country B tax against the tax payable to Country A. Therefore, the tax incentive of 300,000 in foregone tax provided by Country B is effectively transferred to Country A, whose tax increases from 50,000 (if Country B does not provide any tax holiday) to 350,000 (if Country B provides the tax holiday).

Tax sparing provisions can take various forms, and there are serious application issues with all of them.<sup>49</sup> In particular, tax sparing provisions are potentially subject to abuse.

## **7. The application of tax treaties to residents of the other contracting State (non-residents)**

### **7.1 Introduction**

In most situations under the provisions of bilateral tax treaties, it is the source country that is required to give up or reduce its tax on income earned in that country by residents of the other contracting State. Therefore, it is appropriate and necessary for the source country to take the necessary steps to ensure that the provisions of the tax treaty are applied properly. In general, these steps include:

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<sup>49</sup>See paragraphs 72-74 of the Commentary on Article 23 of the OECD Model Convention and paragraphs 16, 17 and 18 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 72-74 of the Commentary on Article 23 of the OECD Model Convention, paragraphs 76-78 of the 2000 OECD Commentary on Article 23, and paragraph 75 of the Commentary on Article 23 of the OECD Model Convention, respectively. See also the 1998 Report by the OECD Committee on Fiscal Affairs, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

- Identifying non-residents subject to source-country tax under the source country's domestic law.
- Gathering information about the income-earning activities of non-residents.
- Determining whether non-residents qualify for treaty benefits.
- Determining the amount of the reduction in source-country tax required by the treaty and the method by which the reduction should be provided.

Some of these steps have been discussed in earlier sections of this chapter and are cross-referenced here. This section focuses primarily on the identification of the relevant non-resident taxpayer and the application of tax treaties to the most important types of income earned by non-residents.<sup>50</sup>

## 7.2 Identification of the relevant non-resident taxpayers

Dealing with issues concerning the application of tax treaties by a source country assumes that it has identified the non-residents that are deriving from it income that is subject to source-country taxation. Obviously, if a source country is not imposing tax on a non-resident because it is not aware that the non-resident is carrying on business in that country or deriving income from it, there is no need to apply the provisions of an applicable tax treaty. The identification of non-residents deriving income from the source country is critical, both for source-country tax purposes generally and for the application of tax treaties.

Many countries use taxpayer identification numbers to identify taxpayers and keep track of their income-earning activities. Such numbers can be readily used for residents but some countries also require non-residents to obtain them in order to claim treaty benefits. Although the conditions for issuing a taxpayer identification number are matters of domestic law, they may have an impact on the availability of treaty benefits. For example, some countries require proof of a non-resident's country of residence as a condition of issuing a taxpayer identification number. It is necessary for countries to balance the

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<sup>50</sup>See also chapter IV, The taxation of non-residents, by Colin Campbell.

administrative convenience afforded by taxpayer identification numbers and the burden imposed on taxpayers. The conditions for obtaining a taxpayer identification number should not be used as a disguised method for discouraging applying for or disallowing treaty benefits.

In addition to taxpayer identification numbers, several countries require non-resident individuals and companies to register with the appropriate authorities in the source country. These registration requirements often apply to non-residents living in the country or doing business in the country. This information should be available to the country's tax authorities.

In some cases, the non-resident may be required to register directly with the tax authorities. The effectiveness of registration requirements appears to vary widely. Requiring non-residents to be registered as a precondition for claiming treaty benefits may have a small positive impact on registration. As noted above, however, if non-residents can derive income from the source country without detection by the tax authorities, claiming treaty benefits is irrelevant.

For countries with exchange controls, there may be a link between getting permission to transfer funds out of the country and the payer's tax obligations. Some countries (for example, Argentina) require non-residents to appoint a local agent as a condition for claiming treaty benefits. Most countries impose withholding obligations on residents who pay amounts to non-residents, which effectively makes the resident payer the non-resident's agent for the payment of tax. This is also the case with respect to interim withholding at source on salaries and wages paid to employees and certain other amounts, including amounts paid to non-residents.

Treaty relief in the form of reduced withholding requires authorization for the resident payer to withhold in accordance with the treaty rate rather than the domestic rate. How this reduction is implemented will determine how efficiently the treaty benefits are delivered. If, as is common practice, the withholding agent is liable for the tax payable by the non-resident if the agent fails to withhold properly, the agent may be unwilling to accept the risk of withholding less than the full amount required by domestic law. Similarly, if the conditions imposed for reduced withholding are too onerous, the withholding agent may withhold at the domestic rate, thus forcing

the non-resident to apply for a refund. For example, is the withholding agent entitled to reduce the amount of tax withheld based on the residence of a recipient, as indicated by the address provided by the recipient, or is more rigorous proof of residence (certification by the foreign tax authorities) required? The former procedure is capable of providing treaty benefits faster and more efficiently but is susceptible to abuse. The latter procedure has more integrity but takes longer and imposes considerably larger compliance burdens.

As noted above, the alternative to delivering treaty benefits through reduced withholding is to require non-residents to apply for refunds of amounts withheld in excess of the treaty rate. Such a refund process requires a large commitment of resources by the tax authorities to operate such a process efficiently. It is not surprising that many countries have decided for practical reasons to implement procedures for delivering treaty benefits that eliminate or reduce the need to make refunds.

The determination of the persons who are entitled to treaty benefits and, in particular, the issues of residence and beneficial ownership, are dealt with above in section 5.

## **7.3 Non-residents earning particular types of income from the source country**

### **7.3.1 Introduction**

In this section, the application of the provisions of tax treaties to different types of income is discussed. It is intended to show how the practical issues concerning their application differ depending on the type of income involved. A detailed discussion of the application of tax treaties to business profits, income from services, and investment income and capital gains is provided in the chapters in this Handbook which deal with those specific topics.<sup>51</sup>

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<sup>51</sup>See chapter V, Taxation of non-residents on business profits, by Jinyan Li; chapter VI, Taxation of non-resident service providers, by Ariane Pickering; and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

### 7.3.2 Business profits

Once it has been determined that there is an applicable treaty, in applying the provisions of that treaty to business profits, the first issue is to determine which of the several provisions of the treaty is relevant. At least six of the distributive articles of the United Nations Model Convention are potentially applicable to business profits: Article 6 (Income from Immovable Property), Article 7 (Business Profits), Article 8 (Shipping, Inland Waterways Transport and Air Transport), Article 14 (Independent Personal Services), Article 17 (Artistes and Sportspersons), and Article 21 (Other Income). Moreover, if dividends, interest and royalties that are otherwise dealt with in Articles 10, 11 and 12, respectively, are effectively connected with a permanent establishment in the source country, they are taxable by the source country in accordance with Article 7. A complete discussion of the various types of business profits is beyond the scope of this overview. It is sufficient to note that the treatment of various types of business profits differs enormously both in terms of the allocation of the right to tax and the practical issues in applying the relevant treaty provisions. A few brief comments with respect to Article 7, the general provision dealing with business profits, and Article 17 dealing with artistes and sportspersons, should serve to illustrate the range of application issues involved.

Under Article 7, the profits derived from a business carried on in the source country by a resident of the other contracting State are taxable in the source country only if the business is carried on through a permanent establishment in that country and the income is attributable to the permanent establishment (subject to a limited force-of-attraction rule in Article 7 of the United Nations Model Convention). The issues that the source country must deal with to apply Article 7 are formidable. They can be summarized as follows:

- First, as dealt with above in this section, the non-residents carrying on business in the source country must be identified.
- Second, as also dealt with above in section 5, the country in which any particular non-resident is resident must be determined.
- Third, it must be determined that the non-resident is carrying on business in the source country through a permanent establishment in that country; this permanent-establishment

determination is intensely factual and requires the tax authorities to have good information about the non-resident's activities in the source country.

- Fourth, it must be determined that none of the other provisions of the treaty apply to the profits because those provisions prevail over Article 7.<sup>52</sup>
- Finally, the profits attributable to the permanent establishment must be determined, which involves the application of the provisions of both Article 7 and the related Commentary and the provisions of domestic law.

In sharp contrast to Article 7, Article 17 of both the United Nations and OECD Model Conventions gives the source country the right to tax income derived from the personal activities of a resident of the other contracting State as an artiste (entertainer) or sportsperson if the activities are exercised in the source country. No permanent establishment is required and the activities do not have to continue for any specified period. Consequently, the application of Article 17 requires a source country to determine that a non-resident has performed activities of an entertainment or sports nature in it and to determine the amount of the income. It is unnecessary to determine the country in which the non-resident is resident because a non-resident artiste or sportsperson will ordinarily be taxable under the domestic law of the source country irrespective of whether a treaty applies.

The primary difficulties involved in applying Article 17 are gathering accurate information about the activities of non-resident artistes and sportspersons in the source country and collecting tax. Information gathering is less difficult with respect to prominent artistes and sportspersons as their performances are likely to be well publicized in the public media. Collecting tax in these circumstances is critical because artistes and sportspersons are often in the source country for a very short time. Article 17 does not impose any limits on how the source country taxes income derived by artistes and sportspersons. As a result, most countries impose tax on such income by way of a withholding tax on the gross revenues. Collection of the tax may be facilitated by arrangements between the tax authorities of the

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<sup>52</sup>See Article 7 (6) of the United Nations Model Convention and Article 7 (4) of the OECD Model Convention.

source country and the local promoters of the event or the owners of the venue. If the tax authorities have difficulty collecting the tax at the time of the event, they may have recourse to Article 27 to seek assistance from the country of residence to collect the tax, assuming, of course, that the treaty contains a provision dealing with assistance in the collection of taxes.

### 7.3.3 Income from services

Several provisions of the United Nations and OECD Model Conventions are potentially applicable to income from services.<sup>53</sup> The purpose of this brief discussion here is to show generally the issues that the tax authorities of the source country must confront in applying the provisions of a relevant tax treaty. These application issues can be summarized as follows:

- First, the non-residents performing services in the source country must be identified.<sup>54</sup>
- Second, the country in which the non-resident service provider is resident must be established in order to determine if the benefits of a treaty are available.
- Third, it must be determined which provision of the relevant treaty is applicable. This determination is based primarily on the nature of the services (for example, employment (Article 15), government service (Article 19), or professional or other independent services (Article 7 or Article 14)).
- Fourth, it must be determined if the threshold for source-country taxation is met under the applicable article. The threshold requirement varies, from the performance of any

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<sup>53</sup>See chapter VI, Taxation of non-resident service providers, by Ariane Pickering. See also Brian J. Arnold, *The Taxation of Income from Services under Tax Treaties: Cleaning up the Mess—Expanded Version*, (online version of article published in February 2011), vol. 65, No. 2, *Bulletin for International Taxation*.

<sup>54</sup>As a general rule, the provisions of the United Nations and OECD Model Conventions restrict the right of the source country to tax income from services to those which are performed in the source country. Article 16 is an exception to this general rule.

income-earning activities in the source country under Article 17 for entertainment and sports activities and for certain employees of resident enterprises and non-resident enterprises with a permanent establishment in the source country, to a time threshold (183 days) for certain other employees and independent contractors, to the necessity for a permanent establishment or a fixed place of business in the source country.

- Fifth, the amount of the income subject to source-country tax in accordance with the treaty must be determined. Some provisions allow the source country to impose tax on the gross revenue derived by the non-resident service provider, while Articles 7 and 14 require tax to be levied on the net income.
- Sixth, the method for imposing and collecting the tax must be established.

As noted above in connection with business profits, the application of the provisions of a tax treaty with respect to income from services presents serious administrative challenges for the tax authorities of source countries, especially developing countries. For practical reasons, some countries have decided to use withholding to collect tax from non-resident service providers.<sup>55</sup> In general, residents paying independent non-resident service providers are required to withhold a specified percentage of the gross amount paid. The non-resident service provider is then required to file a return on a net basis and claim a refund for any excess tax withheld. Since non-resident service providers are taxable only if they have a permanent establishment or fixed base in the source country, some countries provide a system of waivers to allow non-residents to apply to the tax authorities in advance of any payments for an exemption from withholding. Such a system requires the tax authorities to have sufficient information to decide whether a non-resident service provider has a permanent establishment or fixed base in the source country.

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<sup>55</sup>Such a withholding regime may not be effective if the non-resident service provider is paid by another non-resident. In this situation, the payer is not subject to the jurisdiction of the source country, unless perhaps it has a permanent establishment or a fixed place of business in the source country.

#### 7.3.4 Investment Income

The treatment of investment income derived from the source country by a resident of the other contracting State under the provisions of the United Nations and OECD Model Conventions depends on the nature of the income. Dividends, interest, royalties, rental income from immovable property, and capital gains are all dealt with in different articles and in different ways. As with business profits and income from services, a detailed discussion of the application of the provisions of the treaty to investments is well beyond the scope of this overview. The purpose of the brief discussion here is to show the range of application issues concerning investment income that a source country must deal with. A detailed discussion of these issues is found in chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

With respect to dividends and interest under both Model Conventions, and royalties under the United Nations Model Convention, the rate of source-country tax on amounts paid by a resident of the source country to a resident of the other country is limited. The other provisions dealing with investment income do not impose any limits on source-country tax with respect to either the tax base or the rate. Most source countries use withholding taxes imposed on the gross amount paid at a flat rate to collect the tax on dividends, interest, royalties, and rent from immovable property. Some countries also use a withholding mechanism for capital gains realized by non-residents, as discussed below. None of the provisions of the United Nations and OECD Model Conventions restrict the manner in which source-country tax is levied on investment income.

In general, the following steps are necessary to apply the treaty to investment income derived in the source country by a resident of the other contracting State:

- The non-resident recipient of the payment must be identified.
- The residence of the recipient of the payment must be determined in order to establish which treaty is relevant and whether the recipient is entitled to the benefits of the treaty.
- The character of the payment must be determined so that the relevant article of the treaty can be applied.

- In the case of dividends, interest, and royalties, it must be determined whether the recipient is the beneficial owner of the payment.
- The method for collecting the tax must be adopted.

As noted, in most cases, source countries use withholding taxes to collect tax on non-residents deriving investment income. Further, in most cases, the withholding tax is imposed as a final tax, with the result that the responsibility for the steps outlined above to apply the treaty is placed on the person making the payment to the non-resident. The issues involved in balancing the compliance burden on the withholding agent and the delivery of treaty benefits in an efficient manner with integrity are discussed in section 4.4 above.

The provisions of Article 13 of both the United Nations and OECD Model Conventions dealing with capital gains present several difficult application issues. In general terms, the source country is entitled to tax capital gains from the alienation of immovable property located in the source country, the movable property of a permanent establishment or fixed base in the source country, shares of a company and interests in a partnership, trust, or estate if the assets consist principally of immovable property located in the source country.<sup>56</sup> Other capital gains are taxable exclusively in the residence country.<sup>57</sup>

The application of the provisions of Article 13 involves many of the same issues involved in applying the treaty provisions dealing with business profits, income from services, and investment income (for example, the necessity to establish the residence of the taxpayer). These issues are not repeated here. The source country must obtain information necessary to calculate the amount of the gain: the cost of

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<sup>56</sup>Capital gains from the alienation of ships or aircraft operated in international traffic and boats engaged in inland waterways transport and associated movable property are taxable exclusively by the country in which the alienator has its place of effective management: Article 13 (3). Under Article 13 (5) of the United Nations Model Convention, the source country is also entitled to tax gains from the alienation of substantial interests in a company resident in that country.

<sup>57</sup>Article 13 (5) of the OECD Model Convention and Article 13 (6) of the United Nations Model Convention.

the property, the proceeds of the sale, and the costs incurred in connection with the sale. These amounts may require conversion from a foreign currency into the domestic currency of the source country. Finally, the collection of the tax on a capital gain realized by a resident of the other contracting State poses special problems. An obligation to withhold an amount from the purchase price on account of the estimated tax on the capital gain can be imposed on the purchaser. However, such an obligation may be difficult to enforce if the purchaser is not resident in the source country.

The enforcement problem is limited with respect to capital gains because under Article 13 the source country is given the right to tax capital gains in respect of property that, with the exception of substantial interests under the United Nations Model Convention, is physically located in the source country. Consequently, the tax authorities of the source country should be able to take effective enforcement action with respect to any tax payable by a non-resident against the property located in that source country.

## **8. Abuse of tax treaties and the relationship between tax treaties and domestic law**

The provisions of tax treaties can be used in a wide variety of ways to avoid tax.<sup>58</sup> It is important for countries to protect their domestic tax bases from abuse through the improper use of tax treaties. This is a challenging task, especially in light of the general principle that the provisions of a tax treaty generally prevail over the provisions of domestic law in the event of a conflict.<sup>59</sup>

According to the Commentary on Article 1 of both the United Nations and OECD Model Conventions, several techniques are available to prevent tax avoidance through the misuse of tax treaties. These techniques include specific and general anti-avoidance rules in

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<sup>58</sup>See paragraphs 40-99 of the Commentary on Article 1 of the United Nations Model Convention for a description of several of the common treaty abuses.

<sup>59</sup>See chapter X, The improper use of tax treaties, tax avoidance and tax evasion, by Phillip Baker.

domestic law, specific and general anti-avoidance rules in tax treaties, and the interpretation of tax treaties.<sup>60</sup> The United Nations and OECD Model Conventions contain a few provisions that might be considered to be specific anti-avoidance rules, for example: the beneficial-owner concept in Articles 10, 11 and 12; the special-relationship rules in Articles 11 (6) and 12 (6); the taxation of capital gains on shares of land-rich companies in Article 13 (4); and Article 17 (2) dealing with the diversion of income to so-called star companies. Countries may consider the inclusion of additional specific anti-avoidance rules in their bilateral tax treaties. However, the Commentary on the United Nations Model Convention cautions countries about relying exclusively on specific rules to deal with the problem of treaty abuse.<sup>61</sup>

With respect to the use of domestic anti-avoidance rules to prevent the abuse of tax treaties, countries need to ensure first, that such domestic rules are effective and second, that their application to tax treaty abuses is not prevented by the general principle that tax treaties prevail over domestic law. The second issue can be dealt with in a variety of ways, depending on the circumstances of each case. As the Commentary indicates, sometimes treaties contain provisions expressly allowing the application of domestic anti-avoidance rules, such as controlled foreign corporation and thin capitalization rules. In other situations, the treaty uses undefined terms, which require the application of domestic law, including domestic anti-avoidance rules. Finally, the provisions of the treaty can be interpreted so as not to prevent the application of domestic anti-avoidance rules. Thus, for domestic general anti-avoidance rules, whether judicial or legislative in nature, there should be no conflict with the provisions of a tax treaty as long as the domestic rule is restricted to cases of abuse. The critical issue in this regard is, what is an abuse of a tax treaty? The Commentaries on Article 1 of both the United Nations and OECD Model Conventions provide a general test or guiding principle of treaty abuse:

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<sup>60</sup>Paragraphs 10-39 of the Commentary on Article 1 of the United Nations Model Convention and paragraphs 7-26 of the Commentary on Article 1 of the OECD Model Convention.

<sup>61</sup>Paragraph 33 of the Commentary on Article 1 of the United Nations Model Convention.

“A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions”.<sup>62</sup>

Although this principle is broad and general, it provides useful guidance for taxpayers and tax authorities. As the Commentary on Article 1 of the United Nations Model indicates:

“The members of the Committee endorse that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules”.<sup>63</sup>

The Commentary on Article 1 of the United Nations Model provides a discussion of the advantages and disadvantages of including a general anti-abuse rule in the treaty.<sup>64</sup> Any such rule should be applied in accordance with the general principle outlined above as to what constitutes an abuse of a tax treaty.

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<sup>62</sup>Paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention and paragraph 23 of the Commentary on Article 1 of the United Nations Model Convention, quoting paragraph 9.5 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>63</sup>Paragraph 24 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>64</sup>Paragraphs 34-37 of the Commentary on Article 1 of the United Nations Model Convention.

Some treaty abuses can be prevented by interpreting the provisions of the treaty in accordance with their purpose and the good-faith requirement as set out in Article 31 (1) of the Vienna Convention on the Law of Treaties.<sup>65</sup> This interpretive approach to controlling treaty abuse should also conform to the guiding principle in the Commentary on Article 1 as to what constitutes treaty abuse.<sup>66</sup>

The guidance in the Commentary concerning treaty abuse was extensively revised in 2011 for the United Nations Model Convention and in 2003 for the OECD Model Convention. Consequently, there is a serious issue as to the relevance and weight of the revised Commentary for the interpretation of tax treaties entered into before the respective Commentaries on Article 1 of the United Nations and OECD Model Conventions were revised. The Introduction to the OECD Model Convention indicates expressly that subsequent versions of the Commentary should be taken into account for purposes of interpreting tax treaties previously entered into.<sup>67</sup> Some commentators have expressed a contrary view. Ultimately, this issue may be resolved by a country's courts. Nevertheless, the tax authorities should be aware of this issue, especially in connection with the issue of abuse of tax treaties.

In general, the tax authorities of a country should apply the provisions of its tax treaties to prevent tax avoidance and evasion. This requires a careful consideration of the inclusion of anti-abuse rules in tax treaties and the adoption of domestic anti-avoidance rules that can be applied to treaty abuses. However, in addition to ensuring that the appropriate anti-avoidance rules are in place, the tax authorities must have the capacity to interpret, apply and enforce those rules with respect to treaty abuses. In this regard, developing countries face the challenge of balancing the need to provide foreign investors with certainty in order to attract investment with the need to protect

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<sup>65</sup>Paragraph 38 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>66</sup>Paragraph 39 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>67</sup>Paragraphs 33-34 of the Introduction to the OECD Model Convention.

the tax base.<sup>68</sup> To execute this difficult balancing act properly, the tax authorities must have the necessary expertise to apply complex anti-avoidance rules, such as transfer pricing rules, to sophisticated tax avoidance transactions. The development of such expertise within the tax departments of developing countries through experience and training should be a priority.

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<sup>68</sup>Paragraphs 100-103 of the Commentary on Article 1 of the United Nations Model Convention. As noted above, in section 4.5.4, one method of providing a measure of certainty to taxpayers with respect to the possible application of anti-abuse rules is through an advance rulings process.

## Chapter II

### Persons qualifying for treaty benefits

JOANNA WHEELER\*

#### 1. Introduction

The granting of treaty benefits can be a fraught issue for many countries. Treaties are often regarded as an important part of a country's international tax policy and an important tool in attracting foreign investment, yet there is also a concern that treaties can be exploited by taxpayers to obtain benefits which were not intended by the countries concluding the treaty and which do not have any policy justification behind them. Assessing the relative weight of these two concerns can be a difficult balancing act for countries. This chapter aims to assist the tax administrations that have to determine whether or not to grant treaty benefits in specific cases by shedding some light on the policy and technical issues that arise in this respect.

It focuses on the position of a source country that is asked to reduce or forgo the taxing jurisdiction it claims under its domestic law, as the issues are generally most acute, and arise most frequently, for source countries. Issues may also arise in residence countries if the double tax relief granted by a treaty is more generous than the double tax relief granted under domestic law; this could be the case if, for example, the residence State has conceded the creditability of a specific tax under the treaty that it would not regard as creditable under its domestic law, or if the treaty grants a participation exemption for dividends whereas domestic law grants a credit. The substantive issues in respect of residence-State taxation are covered in another chapter.<sup>1</sup> In the context of the present chapter, the important point is that the residence country also has to determine whether a taxpayer is entitled

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<sup>1</sup>See chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

to treaty benefits and this involves the same elements as the determination made by the source country.

Entitlement to treaty benefits is often discussed in the context of the need to ensure that benefits are granted only to persons who are genuinely entitled to them, particularly in the context of treaty shopping. Treaty shopping is the phenomenon that taxpayers set up cross-border structures or flows of income, not for reasons related to the commercial aspects of their business or investment, but in order to make the income fall within the protection of a certain treaty. There is, however, also an opposite side to the coin, namely the need to ensure that treaty benefits are granted in appropriate cases, even though the fact pattern presented to the tax authority does not fall neatly within the wording of the treaty.

Treaties cannot possibly deal in detail with every factual situation that may occur in the relationship between two countries. In order to provide the necessary flexibility in dealing with this complex, and continuously changing relationship, treaties are worded in a rather abstract and general way, setting out basic principles rather than detailed rules. They raise many questions about interpretation and there may be situations in which policy considerations indicate that treaty benefits should be granted even though the treaty does not cater explicitly for the situation under consideration. It is therefore important for the tax authority to be aware of the general principles and policy issues underlying entitlement to treaty benefits in order to be able to make these decisions.

This chapter starts by explaining the three basic steps that have to be taken in determining whether or not treaty benefits are available. It then pulls together the issues raised by various types of conduit structure, which are often a major concern of source countries. It concludes by looking at a number of structures which are not covered explicitly by the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>2</sup> (United Nations Model Convention), in each case highlighting the feature that causes problems and discussing its effect on treaty entitlement issues.

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<sup>2</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

Dealing with these basic steps and structures requires a country applying a treaty to have information about the person claiming treaty benefits and the structure for which treaty benefits are claimed. This need for information can be a serious stumbling block for many source countries, in particular. Although there are a few multilateral tax treaties in existence, this chapter assumes for the sake of simplicity that a tax treaty always has only two contracting States.

## 2. Persons qualifying for treaty benefits

The first step in determining whether a specific treaty applies in a given case is to identify the person who is potentially entitled to the benefits of the treaty. Article 1 of both the United Nations Model Convention and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>3</sup> (OECD Model Convention), which is followed by most concluded treaties, states clearly that the treaty applies to “persons”. Any claim to the benefit of one of the allocation articles must therefore be made and substantiated by a person.

In many cases, it is clear what counts as a “person” for treaty purposes. Individuals are clearly “persons”, as are companies, which are legal persons. The domestic law of most countries, however, also recognizes various other structures and groupings to a greater or lesser degree. Within one State the domestic law is generally clear as to which of these structures or groupings are recognized as distinct taxpayers for income tax purposes, but difficulties can arise in a treaty context. Something that is a taxpayer under the domestic law of a State is likely to be regarded by that State as a “person” for treaty purposes, but the domestic civil law of the other contracting State may be different and then a question arises as to whether the other contracting State also recognizes the person for treaty purposes.

Article 3 (1) (a) of the United Nations and OECD Model Conventions addresses this issue by providing that the term “person” includes an individual, a company and any other body of persons. This

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<sup>3</sup>Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital*, (Paris: OECD, 2010) (loose-leaf).

paragraph is only a partial solution, as it does not provide an exhaustive definition of the term and it leaves open the question of what is meant by a “body of persons”. The Commentaries do state, however, that the term should be interpreted very broadly. Given the object and purpose of the allocation rules of treaties, a strong argument can be made that something that is capable of bearing an income tax liability in a State should qualify as a “person” for treaty benefits.

## **2.1 Types of person**

The most straightforward types of person that can potentially claim treaty benefits are discussed in this section below. Partnerships, transparent companies and trusts all raise further issues and are discussed in section 6. This chapter does not cover the governments of countries and their subdivisions or sovereign wealth funds, all of which are subject to slightly different considerations.

### **2.1.1 Individuals**

Individuals are generally rather straightforward in this context as they are so clearly “persons”. Nevertheless, some issues for treaty entitlement can arise due to different domestic systems for taxing families.

Some countries do not tax each individual separately, but tax them rather in family units, such as husband-and-wife units or, less commonly, a family as a whole. In these cases, there may well be a mismatch between the domestic laws of the two contracting States. Family taxation regimes generally apply, however, only if all the family members concerned live in the same State, and it would be an excessively technical approach to deny treaty benefits because of this tension. The two contracting States would have to agree, however, whether a claim for treaty benefits should be made by the family unit as a whole or whether it should be made by the separate individuals within the family unit.

Other countries deal with the issues raised by families in a different way; these countries treat each individual as a separate taxpayer but they tax certain income of one family member in the hands of a different family member. A common example is the taxation of

investment income received by a child in the hands of a parent, in order to prevent wealthy parents from transferring their investments to their children in an attempt to avoid the effects of progressive rates of tax on the income produced by the investments. In this case there is no doubt that the child and the parent are both separate “persons” for treaty purposes. The treaty issue here is not, in fact, with the first step of identifying a person, but rather with the third step, discussed below, of deciding which person can claim treaty benefits in respect of which item of income.

### 2.1.2 Companies

Companies, like individuals, are generally rather straightforward in this context as they are clearly legal persons and, therefore, clearly “persons” for treaty purposes. Indeed, Article 3 (1) (a) of the United Nations Model Convention specifically defines the term “person” to include companies.

Article 3 (1) (b), in turn, defines the term “company” to mean any body corporate and any entity that is treated as a body corporate for tax purposes. The latter part of this definition means that even a legal structure that does not have the form of a company can be regarded as a company for treaty purposes if it is taxed as a company under domestic law. Once it has been determined, however, that a structure is a “person” for treaty purposes, it is not important to its entitlement to treaty benefits whether or not it is a company.<sup>4</sup>

Many countries allow companies in a corporate group to elect for a tax regime which recognizes that the corporate group forms an economic whole. Such group taxation regimes take many different forms. One approach is to deal with different aspects of the group relationship separately, with one set of rules to deal with inter-corporate dividends, another set of rules to deal with transfers of assets among group members and yet another set of rules to allow the transfer of losses among group members. A more integrated approach requires a computation of profit by each group member separately, but then

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<sup>4</sup>Subject to the one exception of Article 10 (2), where the different limits on source-State taxation depend partly on whether or not the treaty claimant is a company.

aggregates all those results in the hands of the top company in the group and taxes only the top company.<sup>5</sup> At the most extreme end of the scale are countries which deal with all these aspects in one comprehensive regime which ignores the separate legal existence of the group members and imposes tax as if all the group members were branches of the top company in the group.

The latter type of group regime raises questions about the entitlement to treaty benefits of the companies in the group, but these questions do not arise during the first step that is discussed in this section. Even the most integrated group regime does not take away the legal personality of the separate companies in the group, but it does change the incidence of tax liability within the group and this change may have implications for steps two and three in the determination of entitlement to treaty benefits. This issue is discussed in section 6.3 below.

### **2.1.3 Associations and other structures**

In addition to companies, most States have some other legal structures that can be used for business and/or investment purposes, such as associations, foundations and cooperatives. These are some of the most common structures that are not companies, but the civil law of different countries offers a wide array of possibilities, some of which may be unique to a specific country and many of which do not have an exact counterpart in countries with which treaties have been concluded.

If such a structure has legal personality according to the civil law under which it is created, there is no doubt that it is a “person” for treaty purposes and, therefore, potentially able to claim treaty benefits. Similarly, if a structure is taxed in the same way as a company in the country where it is established, it is clear from Article 3 (1) (b) of the United Nations Model Convention that it is to be regarded as a company for treaty purposes.

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<sup>5</sup>In this case, special rules might still be necessary to deal with the distribution of dividends within the group and the transfer of assets among group members, as this regime does not, of itself, remove the economic double taxation on inter-corporate dividends or the crystallisation of a gain on assets transferred within the group.

At the other end of the scale are groupings and structures which do not have enough cohesion to be regarded as a body of persons under Article 3 (1) (a) of the United Nations Model Convention. A consortium, for example, is a term which is often loosely used to denote a number of companies working together on one project; consortia are generally not formally recognized as a grouping under civil law and the formation of a consortium generally does not have any tax consequences which could lead to it being regarded as a “body of persons” for treaty purposes.

In between these two extremes are structures which have some, but not all, of the hallmarks of legal personality.<sup>6</sup> Even though they are not treated as a company for tax purposes there may nevertheless be a tax charge on their income or profit. Although the Commentaries to the United Nations Model Convention state that the term “body of persons” used in Article 3 (1) (a) of the Model Convention is to be given a very wide interpretation, many countries do have questions about the application of treaties to structures with such an intermediate status, especially if their civil law does not include the same legal structure.

Countries take various approaches to this issue. Some countries look for the nearest equivalent in their own civil law and apply the treaty accordingly. Other countries look for particular features as a determinant of whether a structure should be regarded as a person for treaty purposes, such as the ability of the unit or legal structure to conclude contracts. Other approaches are also possible, albeit less common, such as simply regarding all foreign legal structures as companies for tax purposes. Since the publication of the so-called OECD Partnership Report,<sup>7</sup> however, there has been growing acceptance of the principle enunciated in that report, that the source State looks to

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<sup>6</sup>For a discussion of the hallmarks of legal personality see: John F. Avery Jones et al., *Characterisation of Other States' Partnerships for Income Tax*, 56 Bulletin for International Fiscal Documentation 7 (2002), pp. 288-320. Although this article deals with partnerships, which are discussed in section 6 of this chapter, it makes clear that legal personality has many characteristics and that it is possible for a given structure to have some of those characteristics but not others.

<sup>7</sup>*The Application of the OECD Model Convention to Partnerships*, adopted by the OECD Committee on Fiscal Affairs on 20 January 1999.

the tax law of the residence State in determining which structures are regarded as taxable persons for treaty purposes. Partnerships are discussed in more detail in section 6.2 below.

If a structure or grouping is not regarded as a person capable of claiming treaty benefits, there is then an issue as to whether another person is a potential claimant, such as the members of an association or the persons running a foundation. This is similar to the issues considered in Section 6 about the application of treaties to partnerships and reference is made to the discussion there.

### **2.1.4 Permanent establishments and fixed bases**

Permanent establishments are mentioned briefly here in order to emphasize that they are not separate persons and are, therefore, not entitled to treaty benefits in their own right. If a company, for example, which is resident in one country, carries on part of its business through a permanent establishment in another country, it is the company that is the person carrying on business through the permanent establishment. This is so even if the permanent establishment operates quite independently of the rest of the company.

If the company receives income from a third State through the permanent establishment, this analysis leads to results which may appear to be at odds with the economic reality of a permanent establishment. An example may be useful to illustrate this issue. Company R is resident in State R and maintains a permanent establishment in State P. Company R receives a payment of interest from a source in State S which is clearly effectively connected with the permanent establishment.<sup>8</sup> State S has a domestic withholding tax of 25 per cent.

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<sup>8</sup>Income is effectively connected with a permanent establishment if it is a business receipt of the part of the enterprise's business that is carried on through the permanent establishment. For example, if the enterprise sells goods through the permanent establishment and extends customer credit for large orders, interest paid in respect of customer credit would be effectively connected with the permanent establishment if it was paid by a customer which purchased goods from the permanent establishment. Another example is a receipt of royalties in respect of a licence to use technology if the licence was granted by the part of the business that the enterprise carries on through the permanent establishment.

It has concluded a treaty with State R, which limits the source-state withholding tax on interest to 20 per cent, and a treaty with State P, which limits the source-state withholding tax on interest to 15 per cent.

As the interest, from an economic point of view, flows to the permanent establishment located in State P, an instinctive reaction to this situation is often that the State S withholding tax must be limited to 15 per cent under the State S-State P treaty. This reaction forgets, however, the first step in determining entitlement to treaty benefits. The person to whom the interest is paid in this situation is the company; the company receives the interest through its permanent establishment, but there is only one person to whom interest is paid and that is the company. The company is the only “person” capable of being entitled to treaty benefits and, therefore, assuming that the other conditions are satisfied, it is the State S-State R treaty that applies to limit the State S withholding tax to 20 per cent. A similar analysis applies to income that is effectively connected with a fixed base.

There is a growing body of opinion that, certainly in respect of substantial permanent establishments and fixed bases, this result is so inappropriate in economic terms that a permanent establishment or fixed base should be entitled to treaty benefits as if it were a person separate from the enterprise of which it is a part. Nevertheless, the analysis explained here is generally accepted as correct under current treaty law.

By contrast, in the reverse situation, the payment of income through a permanent establishment or fixed base may have an effect on the source of the income. The United Nations Model Convention includes provisions in Article 11 (5) and Article 12 (5) which determine the source of interest and royalties for treaty purposes.<sup>9</sup> These provisions state that the source of such income is in one of the contracting States if the person paying the income is resident in that State. If, however, the payment is borne by a permanent establishment or fixed base which that person maintains in the other contracting State, the source of the income is in the State where the permanent establishment or fixed base is located. To this extent, therefore, the existence

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<sup>9</sup>The OECD Model Convention includes Article 11 (5), but not Article 12 (5), as it does not allow the source-State taxation of royalties. The OECD Model Convention also does not refer to payment through a fixed base.

of a permanent establishment or fixed base does change the source-residence relationship for treaty purposes.

## **2.2 Identification numbers and registration requirements**

Countries need to be able to monitor claims to the protection of their treaties in order to ensure that treaty protection is granted only in appropriate cases. They generally also wish to monitor the flows of income in and out of the country that are subject to treaty protection in order to determine their long-term policy in that respect. Both needs require the collection of information about claims to treaty protection.

The obvious way of ensuring that this information is available to the government is to permit the benefit of a treaty to be given only after a claim for treaty protection has been approved by the tax authority. This claim could be made by the person entitled to treaty benefits or in some cases it could be made by the person paying the income on behalf of the person entitled to treaty benefits.<sup>10</sup> This latter system might be more appropriate, for example, in the case of a bank which has a large number of deposit holders in the other contracting State and which already holds a certain amount of information about those persons. In either case the minimum information required would be what type of person the treaty claimant is, which treaty's benefits are claimed, the residence status of the treaty claimant in the other contracting State and the grounds on which that person claims treaty protection for that income.<sup>11</sup>

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<sup>10</sup>As an alternative to a direct claim by the person entitled to treaty benefits, the claim could also be made by an intermediary on behalf of the person entitled to treaty benefits. This system is particularly appropriate for income that is derived by a collective investment vehicle (CIV) on behalf of a large number of small investors. The OECD has investigated this possibility in detail, leading to the adoption on 23 January 2013 of the Treaty Relief and Compliance Enhancement (TRACE) — Implementation Package for authorised intermediaries such as CIVs. This report can be downloaded from <http://www.oecd.org/tax/exchange-of-tax-information/treatyreliefandcomplianceenhancementtrace.htm>.

<sup>11</sup>Some of the practical considerations relevant to the determination of the residence status of the treaty claimant are discussed in chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold.

An alternative mechanism is to allow persons paying income to apply the treaty themselves and to require someone, either that person or the person claiming entitlement to treaty benefits, to report afterwards that the treaty has been applied. This alternative has the disadvantages, however, that it removes the incentive to make a timely application with the provision of full information and, if the treaty has been applied incorrectly, it leaves the tax authority in the difficult position of trying to correct the position afterwards.

In many cases, a treaty claimant will continue to receive income from the same source over many years, and it would save administrative effort if the determination that treaty benefits are available has to be made only once. On the other hand, the tax authority also has to be aware that the circumstances may change over time. Requiring a self-certification from the taxpayer that the circumstances have not materially changed may help, although it does not obviate the need for the tax authority to remain alert.

Countries will generally want to assign tax identification numbers (TINs) to non-residents who receive domestic-source income, and it may be useful to employ a pattern of TINs which distinguishes between residents, non-residents who are entitled to treaty benefits and non-residents who are not entitled to treaty benefits. In respect of non-residents entitled to treaty benefits, the TIN could also include a feature indicating which treaty applies. The residence country of treaty claimants would almost certainly assign its own TIN to a treaty claimant and, therefore, it would also be useful for the source country to require this information as a condition of granting treaty benefits and to create a link between the two numbers in its registration system so that any information that is obtained from the residence country can be easily matched with the treaty claimant.<sup>12</sup>

Coordination with the tax authority of the residence country would in any event be useful to help monitor the entitlements to treaty benefits that are claimed. Obviously, that has to be done within

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<sup>12</sup>Further information about the administrative procedures for the granting of treaty benefits can be found in: Raffaele Russo, *Administrative Aspects of the Application of Tax Treaties*, 63 Bulletin for International Taxation 10 (2009), pp. 482-488.

the confines of the exchange of information provisions of the applicable treaty and/or an additional tax information exchange agreement (TIEA).

### 3. Residence

Once a person has been identified who is potentially entitled to treaty benefits, the second step is to determine whether that person has the required connection with a treaty partner State. The United Nations and OECD Model Conventions use the residence concept to express this connection and define this concept in Article 4. The general philosophy of this requirement is that a person is entitled to the benefits of treaties concluded by a country only if the treaty claimant has a personal connection with that country; in most cases the required connection is one that leads to the taxation of the person in that country on worldwide income. Although this general philosophy is clear, there are some difficult borderline issues.

This section first discusses the various elements of the residence definition in Article 4 of the United Nations Model Convention, looking first at its basic requirements of Article 4 and then at the issues that arise in connection with persons who have a residence connection with two countries. The discussion then turns to the phenomenon of limitation on benefit (LOB) provisions, which are included by a growing number of countries in their treaties to resolve the shortcomings they perceive of the residence requirement. It concludes with a brief look at the small number of treaty articles that apply regardless of residence.

As noted in the introductory chapter,<sup>13</sup> a source State in applying a treaty has to make a determination about the residence of the treaty claimant in the other contracting State; this determination requires a consideration of the domestic law of the residence State and therefore the source State often requests a certificate issued by the residence State in this respect. In order to improve the reliability of this procedure, States may find it advisable to come to an agreement with

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<sup>13</sup>See chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold, section 5.3.

each other about which government body or department is authorized to issue a residence certificate and the requirements for its validity.

### **3.1 Liability to tax**

#### **3.1.1 Liable to tax and subject to tax**

The first part of the residence definition in Article 4 (1) looks for the “liability to tax” of the person claiming treaty benefits in the country claimed as residence State. In this respect, an important distinction has to be made between two concepts, of being “liable to tax” and being “subject to tax”. There is general agreement as to the basic distinction between these concepts, although there are some difficult borderlines and neither concept is completely clear.

A person is subject to tax if the person has to pay some tax, however small the amount may be. A person is liable to tax if the person is within the scope of the tax charge, even though the person may not be obliged to pay any amount of tax; this situation can occur for a variety of reasons, some of which are explored further below. What is clear is that being subject to tax is a narrower concept than being liable to tax; every person who is subject to tax is also liable to tax, but the group of persons who are liable to tax may also include some persons who are not subject to tax.

An individual, for example, who earns a salary and who pays tax on that salary each year is clearly both subject to tax and liable to tax. At the other extreme is something that is not covered by any tax law at all, for example, a consortium of companies which does not feature in any list of taxable persons in a country’s income or profits tax law and which also does not fall into any residual category in the income or profits tax law; such a grouping is not liable to tax and, therefore, also not subject to tax. In between these two extremes, there are various grey areas in respect of both being subject to tax and being liable to tax.

Does the “subject to tax” concept, for example, cover a person who is taxable at a zero per cent rate? As being subject to tax implies a positive tax liability, most experts would regard such a person as not being subject to tax, as a zero per cent rate is incapable of producing a positive amount of tax to pay. Does the “subject to tax” concept cover a

company which pays no tax on its profits in a year because it has losses to carry forward which exceed the year's profit? Opinions differ about this situation; the company does not have a positive amount of tax to pay in that year, but there is also an argument that the company is subject to tax because the reduction of the losses to be carried forward has the same practical effect as the imposition of a positive tax liability.

A company that incurs losses is, however, liable to tax. The losses mean that it has a zero tax bill, but it is nevertheless within the scope of the tax law. Similarly, an individual may have only a very small amount of income and therefore not pay any tax because his income is all within the nil rate band. In both these cases it is generally accepted that the person is liable to tax because the person is within the scope of the income or profits tax law and would be subject to tax if his/its factual circumstances change (the individual receives more income or the company starts to make profits).

In respect of the "liable to tax" concept, the difficult borderline issues arise primarily in respect of persons who enjoy exemptions for the whole of their income. Such exemptions take a variety of forms.

One example is a person whose entire income happens to be of a type that is exempt for reasons that are not related to the characteristics or status of the person. For example, an individual's only income may be investment income, but even though the amount may be substantial it could all be exempt because it is derived from "green" investments and the legislation exempts the returns on "green" investments. In this case, the individual would generally be considered to be liable to tax; the exemption of the entire income is due to the individual's choice of investments at that time and it is clear that the individual would be taxable in respect of other types of income.

Alternatively, a person may be entitled to an exemption from profits tax for a limited period of time, for example a company which benefits from an incentive regime for five years. Here again, the company would generally be regarded as being liable to tax because the exemption is only a temporary carve-out from the scope of the profits tax.

A much more difficult and controversial example is a person which is within the scope of the income tax law, but which is entitled

to an exemption for the whole of its income due to the nature of the person. An example would be a charitable foundation if the income tax law applies to foundations generally, but grants an exemption for charitable foundations. In such a case, however, the exemption is usually conditional on the person continuing to satisfy certain conditions, for example that the foundation carries on only charitable activities. In this case, opinion is divided as to whether the foundation is liable to tax, a disagreement which is noted in the Commentary to the United Nations Model Tax Convention.<sup>14</sup> The prevailing opinion, however, is that the foundation is liable to tax because the exemption is conditional and therefore does not take the foundation out of the general scope of the income tax law. Similar issues arise in respect of pension funds, which are discussed in more detail in section 6.1.

If, on the other hand, the foundation was excluded from the scope of the income tax law altogether it would not be liable to tax. So if, for example, the civil law of a country provides that foundations have legal personality and the income tax law applies to legal persons generally but excludes all foundations unconditionally, the foundation would not be liable to the income tax.

### **3.1.2 Extent of liability to tax**

A second set of issues about the basic requirement of Article 4 (1) relates to the extent of the liability to tax that is required. The Commentary to the United Nations Model Convention states<sup>15</sup> that this requirement refers to a comprehensive, or full, liability to tax and it is usually interpreted as referring to a liability to tax in respect of worldwide income. This interpretation is reinforced by the second sentence of Article 4 (1) which excludes from the definition persons who are liable to tax only on income from a source in the potential residence State.

This aspect of the definition can cause difficulties of interpretation in respect of a small number of countries which impose income

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<sup>14</sup>Paragraph 6 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraphs 8.6 and 8.7 of the Commentary on Article 4 of the OECD Model Convention.

<sup>15</sup>Paragraph 2 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraphs 3 and 4 of the Commentary on Article 4 of the OECD Model Convention.

or profits tax on a territorial basis, or in other words in respect only of income from a source in the country.<sup>16</sup> If the residence definition is interpreted as demanding liability to tax on worldwide income, it would simply not be possible for a person taxable on a territorial basis to qualify as a resident for treaty purposes, even if the person had a very substantial personal connection with that State. Most experts therefore agree that, in the case of persons subject to a territorial system, the residence definition does not make this demand, but refers rather to liability to the full extent of the country's income tax system.<sup>17</sup>

Case law from India has highlighted a further issue in respect of the required liability to tax that tax administrations should be aware of. This issue emerges from a line of cases<sup>18</sup> on the extent to which a potential tax liability is sufficient to make a person "liable to tax" for treaty purposes. The cases arose in the context of the relationship between India and the United Arab Emirates (UAE) and the question before the courts was whether a person who had a strong personal connection with the UAE could be "liable to tax" in the UAE for treaty purposes even though the UAE did not impose a tax on income. The argument for accepting that this situation creates liability to tax was that, if the UAE did introduce an income tax, the person would most probably fall within its scope. The balance of the Indian case law now seems to be in favour of accepting such a potential tax liability as sufficient to give residence for treaty purposes.<sup>19</sup>

If one accepts the philosophy that treaties are primarily instruments for preventing double taxation, one would expect a treaty to apply only if there were an actual tax liability in both States. However, what the conclusion of the Indian courts reveals is a rather different philosophy about the function of treaties, which sees them primarily

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<sup>16</sup>A territorial basis of taxation sometimes applies only to certain types of taxpayer, such as companies.

<sup>17</sup>In this respect see paragraph 8.3 of the Commentary on Article 4 of the OECD Model Convention.

<sup>18</sup>For example: *Abdul Razak A. Meman In re*, Case no AAR No. 637 of 2004, 9 May 2005; and *Green Emirate Shipping & Travels Ltd v. Assistant Director of Income Tax*, Case no 99 TTJ 988, 30 November 2005.

<sup>19</sup>Palwe, S.S., and Kumar, P., *Liable to Tax: India versus OECD*, Tax Planning International Review: Latest Developments (9 March 2011).

as instruments for allocating taxing claims between States. In this case, the threat of actual double taxation is less important and the reason for looking for liability to tax in a country is only that it indicates a sufficient personal connection between the treaty claimant and the country. A potential tax liability of the type considered in these cases would indicate the same personal connection and would therefore be sufficient. An issue that might be raised by this view, however, is a lack of certainty and clarity about which situations create a potential liability to tax that satisfies this test.<sup>20</sup> Some recent treaties concluded by countries in the Middle East, in particular, deal with this issue by not using the “liability to tax” criterion at all, instead providing explicitly that the treaty applies to persons who have a stated personal connection with one of the contracting States, such as the permanent home of an individual.<sup>21</sup>

### 3.2 Criteria for liability to tax

The liability to tax requirement in Article 4 (1) of the United Nations Model Convention is intended to test the personal connection between a person claiming treaty benefits and the contracting State in which that person claims residence. Article 4 (1), therefore, requires that the liability has to be imposed for a reason that indicates a personal connection and lists a number of factors that satisfy this test. The factors listed are domicile, residence, place of management and, in contrast with the OECD Model Convention, place of incorporation, but also “any other criterion of a similar nature”.

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<sup>20</sup>For two conflicting views on the correctness of this interpretation of the residence definition see: Baker, P., *Double taxation conventions: a manual on the OECD Model Tax Convention on income and on capital* (London: Sweet & Maxwell, loose-leaf), Sec. 4B.07 (September 2002); and Vogel, K. et al., *Klaus Vogel on double taxation conventions*, 3rd edn (London: Kluwer Law International, 1997), p. 229, Para. 24a.

<sup>21</sup>For example, the treaty concluded between Ireland and Qatar on 21 June 2012 provides that in the case of Qatar the term “resident of a Contracting State” includes “any individual who has a permanent home, his centre of vital interest, or habitual abode in Qatar, and a company incorporated or having its place of effective management in Qatar.” In the case of Ireland, the treaty follows the United Nations and OECD Model Conventions in looking for liability to tax as the test of residence.

This residual sweeping-up category demands some consideration of the common element among the specific factors listed so that one is able to determine whether or not another factor is “similar”. Clearly all the listed factors relate to the personal circumstances of the person claiming treaty benefits. In practice, given the way in which countries generally define the reach of their taxes, any liability to tax on worldwide income or profit is likely to satisfy this condition.

The inclusion of the place of incorporation of a legal entity in this list of criteria may seem, at first sight, to be subject to a risk of abuse, as the place of incorporation is rather a formal criterion. It is possible, for example, for a company to be incorporated under the law of a country but to have no substantive connection with that jurisdiction at all because the shareholders are resident in other countries and the company’s management and business are both carried on outside of that jurisdiction. This situation can be the result of the historical development of the company and its business, but it can also be a deliberate strategy aimed at claiming the benefit of treaties concluded by the State. Such a strategy is, of course, increasingly feasible in an age in which global communication has become so easy that many activities can be carried on remotely.

On the other hand, it is questionable whether the specific mention of the place of incorporation is any different in substance from Article 4 of the OECD Model Convention, as the place of incorporation would be included in the residual category in that model of “other criteria of a similar nature”. Section 5 below, on conduit structures, discusses the dangers of this criterion and some possible responses by States.

### **3.3 Dual residence**

The final aspect of the liability to tax requirement is that the liability has to be imposed by the domestic law of the contracting State in which treaty residence is claimed. In other words, the Model Conventions rely on the view taken by the contracting States as to whether a person has a sufficient connection with a State to qualify as a resident there. So if, for example, a country taxes the worldwide profit of companies that maintain their headquarters in the country, all such companies would be resident in that country for treaty purposes, even though the

country's treaty partners use different criteria for the imposition of tax on worldwide profit.

One of the consequences of this approach is that it is possible for one person to qualify as a resident of both the contracting States to a given treaty, because countries have different criteria for imposing unlimited taxation and also because many countries use alternative criteria for this purpose. In this case, the dual residence has to be resolved before the allocation articles of the treaty can be applied, as these articles are based on the assumption that the person is resident in only one of the contracting States. Article 4, therefore, provides rules, known as the tiebreaker rules, for allocating the person's residence to one of the States for treaty purposes. It is important to note that the tiebreaker provisions apply only for treaty purposes; they do not change the domestic law of either contracting State, so the person remains resident in both contracting States under their respective domestic law.<sup>22</sup>

### **3.3.1 The tiebreaker provisions and unresolved dual residence**

The United Nations Model Convention has two tiebreaker provisions, one for individuals and one for all other persons. The tiebreaker provision for individuals is Article 4 (2), which sets out a hierarchy of criteria, starting with a substantive and factual criterion and applying progressively more formal tests if the previous tests fail to resolve the dual residence. The substance of this tiebreaker provision is relatively straightforward, although there is always a risk of differing interpretations of the tiebreaker tests it uses by the two contracting States to a treaty.

The tiebreaker provision for companies and other persons who are not individuals is Article 4 (3), which provides only one substantive

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<sup>22</sup>The domestic law of some States does, however, remove the residence of the person if the State "loses" under the tiebreaker provision of an applicable treaty. The treaty itself does not change the domestic law of the contracting States; all it does is express the agreement between the two contracting States to limit the application of their domestic law. But the contracting States are free to adopt rules in their domestic law which apply when the application of the treaty leads to a certain result.

test, namely the place of effective management (POEM). In this case, there is no recourse to progressively more formal criteria if the POEM test fails to provide a solution. Indeed a fall-back test is not necessary if one accepts, as the Commentary to the OECD Model Convention states, that an entity can have only one POEM at any one time,<sup>23</sup> although the Commentary to the United Nations Model Convention does not include this statement.

The Commentaries on Article 4 (3) of both the United Nations and the OECD Model Conventions are rather short and they do not include any explicit discussion of many of the pressures that are increasingly placed on the POEM concept. Modern communications methods such as video-conferencing, for example, make this an increasingly difficult concept to apply.<sup>24</sup> The same holds true of modern management styles which do not confine the management of companies in a group to each individual company, but rather manage them in a “horizontal” fashion across the group.

Aside from these pressures, the interpretation of the term can also be subject to differences of emphasis and perception in respect of the level of management and the types of decision that it refers to and the relative importance of the factual and legal responsibility within the entity’s structure. The context of the POEM concept suggests strongly that it should be given a single, treaty meaning; to do otherwise would defeat the very point of having a tie-breaker provision. Yet, in practice, the way in which it is interpreted may be coloured by the domestic law of the person applying the treaty.<sup>25</sup> If two treaty partner States disagree on the interpretation of the concept, it would be necessary to use the mutual agreement procedure in order to resolve this disagreement.

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<sup>23</sup>Paragraph 24 of the Commentary on Article 4 of the OECD Model Convention.

<sup>24</sup>These difficulties have been discussed in a discussion paper published by the OECD in February 2001: *The Impact of the Communications Revolution on the application of ‘Place of Effective Management’ as a Tie Breaker Rule*, available at <http://www.oecd.org/tax/treaties/1923328.pdf>.

<sup>25</sup>See John F. Avery Jones, *Place of Effective Management as a Residence Tie-breaker*, 59 Bulletin for International Taxation 1 (2005), pp. 20-24, reporting on a seminar discussion at the 2004 congress of the International Fiscal Association.

The ease of modern communications and transport has also made it increasingly possible to manipulate the residence of corporations by moving their management to the desired country for tax planning purposes. These pressures have caused some States to use an alternative tiebreaker provision in their treaties which relies entirely on the mutual agreement procedure to resolve the dual residence of non-individuals. An example of such a provision is now included in the Commentary to the United Nations Model Convention.<sup>26</sup> This suggested provision requires the competent authorities only to “endeavour” to resolve the matter. It clearly contemplates the possibility that they will not be able to do so, stating that in that case the person is not entitled to the benefits of the treaty at all, except to the extent that the competent authorities agree to grant treaty benefits. Some concluded treaties go even further and do not even oblige the competent authorities to endeavour to resolve the matter, but provide only that non-individuals that are resident in both contracting States are denied the benefits of the treaty, except to the extent determined by the competent authorities.

In either case, subject to any relief granted by the competent authorities, a company or other person that does not have its dual residence resolved continues to be taxable in both States as a resident. It is, therefore, likely to be taxable on its worldwide income in both States, although this means that it would also be entitled to take deductions in both States and carry forward any losses in both States.

If the company receives income from a third State, it would probably be able to claim unilateral double tax relief in respect of that income in both the residence States. If, in this case, both residence States apply the exemption method, the company would not suffer any double taxation. It would also not suffer any double taxation if one residence State applies the exemption method and the other residence State grants a credit for the third-State tax. However, if both residence States use the credit method, there is a question as to whether either residence State would grant a credit for any residual tax levied by the other residence State on the third-State income. Some States, for

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<sup>26</sup>Paragraph 10 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraph 24.1 of the Commentary on Article 4 of the OECD Model Convention.

example, may refuse to give a credit for tax that is not levied by the source State of the income.

The company may also receive income from one of the two residence States. In this case the residence State that is also the source State is unlikely to grant any double tax relief, although the other residence State may do so.

### **3.3.2 Effect of successful tiebreaker application**

If a tiebreaker provision of a treaty is applied to resolve the dual residence of a person, either an individual or an entity, it becomes possible to apply the allocation rules of that treaty. There is also an increasing acceptance of the argument that the resolution of dual residence under the treaty between a person's two residence States may also have implications for a treaty concluded between one of those residence States and a third State which is the source of income derived by the dual resident person.

This argument is now accepted in the Commentary to the United Nations Model Convention.<sup>27</sup> It is based on the second sentence of Article 4 (1), which excludes from the residence definition persons who are liable to tax in a contracting State only in respect of income from sources in the State. This exclusion was included originally to deal with diplomatic and consular staff, to ensure that they did not receive the benefit of treaties concluded by their work State but only the treaties concluded by their "home" State. It does, however, express the general intention of Article 4 to restrict the benefits of treaties concluded by a country to persons whose connection with a country is considered strong enough to justify that country taxing the person on worldwide income.

This exclusion is now generally understood to support the argument that if a person is resident in two countries under their domestic law, and there is a treaty between those two countries which resolves the dual residence in favour of one of them, the person is entitled to

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<sup>27</sup>Paragraph 4 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraph 8.2 of the Commentary on Article 4 of the OECD Model Convention.

treaty benefits only as a resident of that country. If, for example, a person is resident in both State L and State W and the tiebreaker allocates the person's residence to State W (the winner State), the overall effect of the allocation provisions in that treaty is that State W retains the right to tax the person on worldwide income, subject to the obligation to grant double tax relief in respect of income that may be taxed in State L. State L (the loser State), on the other hand, is permitted to tax only certain items of income from a source in State L.

If State L also has a treaty with a third State (State T), the issue then arises as to whether the person can claim the benefit of that treaty as a resident of State L. As the State L tax liability on the person is limited by the State L-State W treaty to income from sources in State L, the Commentary states that the person is excluded from claiming treaty residence in State L by the second sentence of Article 4 (1) in the State L-State T treaty.

This line of reasoning can be of assistance to States in combating the use of companies incorporated in a State in order to obtain the benefits of treaties concluded by that State. For example, in a case in which a company incorporated in one State (State I), but effectively managed in a second State (State M), claims treaty benefits in respect of income from a source State (State S), if each pair of States has concluded a treaty, this line of reasoning prevents the company from claiming the benefit of the State S-State I treaty. However, it is entitled only to the benefit of the State S-State M treaty, or in other words the treaty between the source State and the State with which the company has the more substantial connection. The usefulness of this line of reasoning to the source State depends, however, on State I having concluded a wide treaty network.

### **3.4 Limitation on benefit articles**

The difficulties with the residence article in the model treaties have led an increasing number of States to include limitation on benefit (LOB) articles in their treaties. An LOB article, essentially, backs up the residence definition by requiring the person claiming treaty benefits to demonstrate more substance in the person's connection with the residence State. It is not usually the intention of States to demand full compliance with the LOB provision every single time that treaty

benefits are claimed, but rather to give the tax authority a tool which can be invoked if the authority is dubious about a specific claim to residence. An LOB provision does this by enabling a tax authority which has been presented with a residence certificate to require the treaty claimant to demonstrate that it satisfies one of the tests in the LOB provision, thereby shifting the burden of proof back to the treaty claimant.<sup>28</sup>

LOB provisions are targeted at the persons most likely to be involved in structures set up in order to claim treaty benefits. They, therefore, do not usually apply to individuals or to the contracting States themselves. Although they can also apply to other persons, this section refers to companies for the sake of simplicity.

LOB provisions vary from one treaty to another, but there are a number of factors which are commonly specified as indicators of an acceptable connection with the residence State. One such factor is that the company is quoted on a stock exchange. Treaty shopping structures are unlikely to use quoted companies, as the widespread ownership of a quoted company is incompatible with the aim of streaming income through a favourable structure to the persons who set up the structure. Details of this test that vary from one treaty to another are the percentage of the share ownership that has to be listed on a stock exchange, whether the listed share ownership has to be directly in the company or whether it can be indirect, and which stock exchanges are accepted for the purposes of this test.

Another common test, which applies to unlisted companies, consists of two factors which together indicate that the company is not being used to route income in order to obtain treaty benefits. One part of this test looks at the share ownership of the company claiming treaty benefits; if the ultimate owners of the company would have been entitled to comparable treaty benefits in their own right, it is unlikely that they have set up the company in order to route the income to themselves. The second part of this test looks at the flow of income through the company in order to ensure that it is not being used to

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<sup>28</sup>Paragraph 56 of the Commentary on Article 1 of the United Nations Model Convention, quoting paragraph 20 of the Commentary on Article 1 of the OECD Model Convention, provides the text of a model LOB provision. Only the main features of this suggested text are commented on here.

route income to persons who would not have enjoyed treaty protection if the income flowed to them directly. Again, the detail of this test varies from one concluded treaty to another.

The first two tests described above apply to the company claiming treaty benefits. The third common test relates, in contrast, to specific items of income for which treaty benefits are claimed. This test looks at whether the income is received as a genuine receipt of an active business carried on by the company in its residence State. To the extent that this third test looks at specific items of income rather than the treaty entitlement of the company as such, it goes beyond the role of backing up the residence definition.

Most LOB provisions also include a sweeping-up clause which gives the tax administration discretion to grant treaty benefits in cases which are not covered by the specific clauses of the LOB provisions but in which the tax authority determines that the company is not part of a structure set up in order to obtain treaty benefits.

Although LOB provisions are becoming increasingly popular, they are complex. Drafting the detail of the tests they set out requires a thorough knowledge of the economy and tax system of the two contracting States to the treaty in order to ensure that the provision targets the appropriate structures. LOB provisions also require considerable effort on the part of the tax authority to apply satisfactorily, both in selecting the cases in which to use the provision and in assessing the information provided by the treaty claimant. For these reasons, countries with limited resources in their tax administration generally prefer to use simpler provisions to combat treaty shopping. Section 5 discusses some of these alternatives.

### **3.5 Articles for which no residence is required**

Although residence is a vital element in determining entitlement to most of the benefits of a treaty, there are three Articles that are explicitly stated to apply regardless of the residence of the taxpayers concerned. Two of these concern the administration of taxes: Article 26 on the exchange of information; and Article 27 on assistance in the collection of taxes, which was added to the United Nations Model Convention in 2011.

The third one is Article 24, the non-discrimination article. The main rule of this Article applies on the basis of nationality and explicitly states that it also applies to persons who are not resident in either State. Residence is relevant, however, to the extent that a difference in the residence situation of two persons is explicitly stated to justify a difference in the tax treatment of those persons.

A small number of the allocation articles in the United Nations Model Convention do not refer explicitly to the residence of the taxpayer who enjoys the benefit of the article. This is the case, for example, with Article 8 on shipping, inland waterways transport and air transport, and two paragraphs of Article 19 on government service. Nevertheless, these Articles are not expressed to be an exception to the general residence requirement of Article 1 and it is unlikely that they are intended to be such.

#### **4. Income for which treaty protection is claimed**

The third step in ascertaining whether treaty benefits are available concerns the specific item of income for which treaty protection is claimed. The treaty applies to persons who are resident in one or both contracting States, but the allocation articles apply to specific items of income or profit. Once it has been established that a person is entitled to treaty benefits as a resident of one of the contracting States, there still remains a question as to which items of income are covered by that treaty entitlement.

##### **4.1 “Derived by”, “paid to”, etc.**

The United Nations and OECD Model Conventions use a variety of terms to denote the connection between a person and an item of income that gives the person entitlement to treaty benefits in respect of that item of income. The most common term used is that the income is “derived” by the person, but the Model Conventions also use other terms such as “paid to”, “received by” and the profits and gains “of” a person. It is unlikely, however, that any substantial difference among these terms is intended.

None of these terms is defined in the Model Conventions. Article 3 (2) therefore applies, with the direction that their definition

is to be taken from the domestic law of the State applying the treaty, unless the context requires otherwise. There have been very few suggestions that the context does require a treaty meaning for these terms. Indeed, given the variety of ways in which States attribute income to a person<sup>29</sup> it would be extraordinarily difficult to establish a generally accepted meaning for them.

One provision in the Model Conventions does deal specifically with the connection between an item of income for which treaty protection is claimed and the person making the claim: the beneficial ownership requirement of Articles 10, 11 and 12, which is discussed below. Article 17 (2) also has some relevance to this issue, although it does not lay down any requirements about the connection between the income for which treaty protection is claimed and the person making the claim. Quite the contrary, in fact, as the purport of this provision is that the lower threshold for the source-State taxation of remuneration paid to artistes and sportspersons for their personal activities cannot be avoided by the simple expedient of having the remuneration paid to a different person.

The Commentary on Article 1 of the United Nations Model Convention discusses various aspects of the connection between the person claiming treaty benefits and the income for which treaty protection is claimed in the context of treaty abuse and anti-avoidance law. The general tenor of these discussions is that artificially routing income to a person who is in a position to claim treaty entitlement should not be an effective method of obtaining treaty benefits. So, for example, paragraph 56<sup>30</sup> of the Commentary on Article 1 of the United Nations Model Convention suggests a provision to combat the assignment of assets in order to create an artificial treaty route for the income produced by the assets. Similarly, paragraph 80 of the Commentary on Article 1 of the United Nations Model Convention suggests a provision to deny treaty benefits for interest paid in back-to-back arrangements.

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<sup>29</sup>On this point, see the general report and branch reports in: *Conflicts in the Attribution of Income to a Person*, International Fiscal Association, Cahiers de Droit Fiscal International (Deventer, The Netherlands: Kluwer, 2007), Vol. 92b.

<sup>30</sup>Quoting paragraph 21.4 of the Commentary on Article 1 of the OECD Model Convention.

Section 5 below, on conduit structures, discusses the artificial routing of income in more detail.

Although still part of the discussion on anti-avoidance measures, the Commentary on Article 1 of the United Nations Model Convention also makes the more general observation that the basic rules of domestic law for determining which facts give rise to a tax liability are not addressed in treaties and are not affected by them.<sup>31</sup> One aspect of those basic rules of domestic law is the determination of which person is taxable in respect of which item of income. This observation, in other words, reinforces the conclusion drawn above that the determination of the taxable person is an issue for domestic law. This conclusion is not without its problems for the interpretation of treaties, however, and section 6 below discusses some problematic issues in this respect.

## **4.2 Beneficial ownership**

The beneficial ownership requirement of Articles 10, 11 and 12 is one of the most extensively discussed concepts in the United Nations and OECD Model Conventions. The purpose of this section, therefore, is not to examine this concept in detail but only to highlight the questions that have led to discussion. A bibliography is provided at the end of this chapter for those who wish to study this topic further.

### **4.2.1 Purpose of the term**

Even the very purpose of the beneficial ownership concept is a question that is frequently posed. Is the beneficial ownership requirement an anti-avoidance rule, or does it have a more neutral, substantive role in determining which persons are entitled to treaty benefits in

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<sup>31</sup>Paragraph 21 of the Commentary on Article 1 of the United Nations Model Convention, quoting paragraph 22.1 of Commentary on Article 1 of the OECD Model Convention. This citation does not include the specific reference in paragraph 22.1 of the OECD Commentary to domestic law that results in “a redetermination of the taxpayer who is considered to derive such income” but, given the manner in which the citation is made, it seems unlikely that any great significance should be attributed to this omission.

respect of dividends, interest and royalties? Proponents of the latter view argue that the concept is badly targeted as an anti-avoidance rule and that there are other, more effective ways of dealing with the abuse of treaties. The Commentary on Article 1 of both the United Nations and OECD Model Conventions, however, comes down unequivocally on the side of the beneficial ownership requirement as an anti-avoidance measure.<sup>32</sup>

If beneficial ownership is used as an anti-avoidance concept, the question then immediately arises as to why its use is limited to three articles in the Model Conventions. The obvious answer is that the three types of income affected are the types most likely to be the subject of treaty shopping. Some concluded treaties do, however, apply the concept to other types of income; the United States Model Income Tax Convention of November 15, 2006 applies it to pensions, annuities and income covered by the Article on other income; and in some concluded treaties the requirement applies to all the allocation articles in the treaty.<sup>33</sup>

#### **4.2.2 Relationship with the term “paid to”**

Another important question that has been raised in connection with the beneficial ownership requirement is whether it substantiates the wording in Articles 10, 11 and 12 that refers to income “paid to” a person, or whether it is an additional requirement. In other words, is it enough that the beneficial owner is a resident of a contracting State, even if the formal payment is made to a person resident elsewhere? Or do these Articles apply only if two conditions are fulfilled, namely that: the income is formally paid to a person resident in the other contracting State, and the beneficial owner is also resident in the other contracting State?

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<sup>32</sup>Paragraphs 31 and 55 of the Commentary on Article 1 of the United Nations Model Convention and paragraph 10 of the Commentary on Article 1 of the OECD Model Convention.

<sup>33</sup>For example: paragraph 4 of the Protocol to the Croatia–Israel treaty of 29 September 2006; paragraph 1 of the Protocol to the Pakistan–Spain treaty of 2 June 2010; paragraph 7 of the Protocol to the Portugal–Uruguay treaty of 30 November 2009; paragraph 2 of the Protocol to the Spain–Senegal treaty of 5 December 2006.

The wording of these three Articles could be taken to suggest the latter interpretation, but it is generally regarded as incorrect. The Commentaries on the United Nations Model Convention<sup>34</sup> state that the limitation of the source-State tax applies if the beneficial owner of the income is resident in the other contracting State, even if the income is paid to an intermediary resident elsewhere.

Further support for this position can be drawn from a comparison with the OECD Model Convention which, in Article 12, uses only the beneficial ownership concept and does not refer at all to the income being “paid to” a resident of a contracting State. Many concluded treaties also use the beneficial ownership in this way, in Article 12 and/or Article 11. In these treaty articles, in other words, beneficial ownership is the only factor connecting the treaty claimant with the income for which treaty protection is sought. One would not expect the reach of these Articles to be materially different from that of comparable articles that use the “paid to” wording. This conclusion is further reinforced by looking at the consequences of interpreting “paid to” and beneficial ownership as two separate requirements, as this interpretation would create a considerable danger that no treaty benefits would be granted at all if income were paid to a person resident in one State while the beneficial owner were resident in a different State, even though both those States had a treaty with the source State.

#### **4.2.3 Meaning of the term**

Perhaps the biggest question of all, however, is the meaning of the term “beneficial owner”, as it is not defined in the Model Conventions. An initial issue in this respect is whether the term has an independent, international treaty meaning, or whether it is defined, according to Article 3 (2), by reference to the domestic law of the State applying

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<sup>34</sup>Paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, and paragraph 5 of the Commentary on Article 12 of the United Nations Model Convention, quoting respectively paragraphs 12-12.2 of the Commentary on Article 10 of the OECD Model Convention, paragraphs 9-11 of the Commentary on Article 11 of the OECD Model Convention, and paragraphs 4-4.2 of the Commentary on Article 12 of the OECD Model Convention.

the treaty. There is a large body of opinion that in this case the context does require that the term is given a treaty meaning independent of domestic law. Certainly the discussion in the Commentaries<sup>35</sup> strongly suggests that at least the wider contours of the concept have an independent treaty meaning. Nevertheless, some of the literature is devoted to ascertaining various national meanings of the term.

Many possibilities have been offered as to the content of the beneficial ownership concept and consensus on this point is still very far away. Some of the suggestions for an independent treaty meaning are: that it simply excludes agents and nominees from obtaining treaty benefits; that it refers to a person who is liable to tax on the income in the person's residence State; that it has a substantive meaning that can be derived from the common-law origins of the term; and that it has a substantive meaning that can be derived from the context in which it used. It is not within the scope of this chapter to attempt to suggest which of these meanings, if any, is the correct one, and reference is made to the bibliography at the end of this chapter in this respect.

## 5. Conduit structures

Conduit structures are maybe the greatest threat to the integrity of a country's tax treaty network. They take different forms and there are, accordingly, various remedies available to countries which are confronted with them. Although many of these issues have already been touched on in this chapter, it is nevertheless useful to set them out here in the specific context of conduit structures.

This section starts by addressing the characteristics of conduit structures that cause problems in connection with the application of treaties. These problems generally arise in the context of the second and third steps discussed above in the determination of whether treaty benefits are available, and, therefore, the discussion here focuses on

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<sup>35</sup>See also the discussion paper published by the OECD on the beneficial ownership concept on 20 April 2011: *Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Tax Convention*. A revised version of the proposals made in this paper, published on 19 October 2012, is available at <http://www.oecd.org/ctp/treaties/Beneficialownership.pdf>.

those two aspects. The specific characteristics of conduit structures do not usually give rise to problems in connection with the first step in this process, namely the determination of whether the legal forms used are “persons” for treaty purposes. Although many legal forms can be used for conduit purposes, they are usually forms that qualify as persons for treaty purposes.<sup>36</sup> This section will, for the sake of simplicity, confine the discussion to companies.

The Commentary on Article 1 of the United Nations Model Convention includes an extensive discussion about treaty shopping and possible remedies against it. Those remedies include the application of general anti-avoidance principles and judicial remedies in domestic law. These general defences are discussed in another chapter; the present chapter focuses on specific defences within the treaty.<sup>37</sup>

One of the problems faced by developing countries, in particular, in their attempts to combat conduit structures is a lack of information and the resources to obtain the necessary information. In other words, in addition to including the appropriate measures in a treaty, it is also necessary for countries to develop strong exchange of information networks. One measure that may help is a requirement for treaty claimants to provide a self-certification that they do indeed satisfy all the conditions for treaty entitlement. Alternatively, the requirement might be for certification by an independent auditor. It may not be workable to require a certification in every single case, in which case some guidelines would be necessary as to when the requirement applies. Experience might suggest that the certification is particularly appropriate in respect of certain treaties, for example, or in respect of treaty claimants with a certain type of ownership. Obviously the tax administration still has to remain vigilant in deciding whether or not to accept the certification.

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<sup>36</sup>A mismatch between two countries in their characterisation of a particular legal form as a person for treaty purposes is sometimes deliberately created as part of tax avoidance strategy, but this issue is not discussed here as it is not a necessary element of a conduit structure.

<sup>37</sup>See chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

## 5.1 Characteristics of conduit structures

The essence of conduit structures is that they route income in an artificial way so that it falls under the protection of a treaty that would not apply in the absence of the structure. Conduit structures take many forms, but what they have in common are two interrelated features: the artificial routing of income through multiple layers of ownership; and a disparity between the legal and economic views of the structure.

The income flow generally consists of income which is paid to the owner of an asset, such as dividends, interest, royalties and rent. This feature makes it possible to direct the income flow by placing the ownership of the assets in countries selected to create a favourable route. The income, in other words, is diverted away from the most direct route; instead it takes a more circuitous route, through multiple layers of asset ownership, before it reaches its final destination. The structure may also involve the use of unusual vehicles in a commercial context, such as foundations, if they are necessary to ensure that the domestic law of the countries through which the income flows does not negate the advantages of the structure.

This artificial routing of the income leads to the second common feature of conduit structures, namely the disparity between the legal and economic views of the structure. The claim to treaty benefits of a company that is part of a conduit structure relies on the legal view. The company is usually incorporated in the conduit State and, therefore, resident in that State under its domestic law. It is legally entitled to the income for which treaty protection is claimed and the income is usually paid to it. On the face of it, therefore, the company satisfies the conditions in the United Nations and OECD Model Conventions for claiming treaty benefits in respect of the income. The economic view is rather different, however.

In an extreme case, the conduit carries on very little activity in its residence State, or none at all, other than owning assets, collecting the income produced by the assets and making payments. It has minimal management which could, furthermore, be carried on outside the conduit State, often by employees of other companies in the corporate group which uses the structure or by employees of the group's advisers. Virtually all of the income collected by the company

is used to make payments which are deductible in the conduit State, and those payments are made to other members of the group who are resident outside that State. As a result, the tax liability of the conduit in its residence State is minimal.<sup>38</sup>

In this situation, the economic view demands that treaty benefits are refused, as the economic connections between the company and its claimed residence State and between the company and the income for which it claims treaty protection are both so tenuous. The challenge for countries concluding and applying treaties is to discover the cases in which the legal view is so far removed from the economic reality that treaty protection should be refused, to define those situations with sufficient accuracy and to create appropriate legal tools for combating these structures.

## **5.2 Residence issues**

One major point of concern in respect of conduit companies is the claim to residence for treaty purposes in a contracting State. The fundamental problem here is that there are two different policy issues at play.

One policy issue is whether a State regards a company as resident for its domestic law purposes, such that it wishes to tax the worldwide profit of the company. In this case, most States regard rather a moderate connection as a sufficient basis for residence, such as the simple formality of incorporation in the State. Few States require that the company, for example, carries on a substantive business in the State in order to be resident there, although this factor may be one of a number of alternative grounds leading to residence.

The other policy issue is whether a source State regards a company as having a sufficient personal, or residence, connection with another State to justify granting the benefit of a treaty it has concluded with that other State. Source States are generally reluctant to apply a

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<sup>38</sup>Conduit structures often also take advantage of certain features of domestic law, such as a participation exemption for incoming dividends, no withholding tax on outgoing payments or other favourable treatment of certain types of income. The discussion here, however, is restricted to the application of treaties.

treaty to reduce their domestic tax claim on the basis of a very slight connection between the company and the other contracting State.

Article 4 of both the United Nations and OECD Model Conventions does not, however, set out an independent treaty test of residence; it relies on the domestic law of the claimed residence State to specify the connecting factors that make a person resident there for treaty purposes. The treaty definition, in other words, refers to a source of law designed for a different purpose, thereby introducing a policy conflict into the treaty. It is for this reason that many countries have started using the limitation on benefit (LOB) clauses discussed above.

For countries that do not wish to engage in the complexities of LOB provisions, however, there are some alternatives. One possibility, suggested in the Commentary on Article 1 of the United Nations Model Convention,<sup>39</sup> is that a shell company with no employees and no substantial economic activity may be disregarded for tax purposes by some countries on the basis of their general anti-abuse rules or judicial doctrines. This possibility is available, however, only in extreme cases.

Other possible responses look at the liability to tax of the conduit company in its claimed residence State; if it is not liable to tax there on its worldwide income there may well be an argument that it does not qualify as a resident of that State for treaty purposes. One reason that it may not be liable to tax on its worldwide income is that it is subject to a special tax regime. In this respect, there is a dividing line that has to be carefully observed; if the general tax regime of the claimed residence State does not impose liability on the foreign income of resident companies, it is difficult to argue that the company is not subject to the full extent of the country's tax regime. However, if the company enjoys the benefit of a special territorial tax regime, particularly one designed to attract companies owned by non-residents, there is a strong argument that the second sentence of Article 4 (1) prevents it from claiming treaty residence in that State.<sup>40</sup>

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<sup>39</sup>Paragraph 72 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>40</sup>See in this respect also paragraph 4 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraph 8.2 of the Commentary on Article 4 of the OECD Model Convention.

Alternatively, a conduit company may not be liable to tax on worldwide income in its claimed residence State if its management is carried out in a third State. If there is a treaty between the State of incorporation and the third State, the residence tiebreaker provision of that treaty would generally assign the company's residence to the third State. In this case, the source State can use the argument explained in section 3.3.2 above to refuse treaty benefits.

### **5.3. Issues related to the income for which treaty protection is claimed**

The second major point of concern in respect of conduit companies is their claim to treaty protection for specific items of income. In this case, the company is able to defend its claim to residence for treaty purposes, maybe because it does carry out economic activity in that State and/or its management is carried out there, but the connection between the company and the income is too slight to justify giving treaty benefits to the company in respect of that item of income.

The obvious answer to this concern is the beneficial ownership requirement, if it is the protection of Article 10, 11 or 12 that is claimed. If the conduit company does indeed do nothing more than collect income on behalf of another person, it is nothing more than an agent or nominee and therefore not the beneficial owner. In most cases, however, the conduit effect is achieved in a different way, by what is known as base erosion. Base erosion means that the income for which treaty protection is claimed is taxable as the income of the conduit company in its residence State, but that the conduit company also claims deductions for outgoing payments which greatly reduce, or erode, the income for which treaty protection is claimed. If, as is often the case, those payments are made to persons resident outside the conduit company's residence State, very little tax is collected by the conduit company's residence State on the income for which treaty protection is claimed.

A conduit structure of this sort can be created using a company which is set up specifically for this purpose, but it can also be created using a company which exists for genuine commercial purposes. In the latter case, the conduit company could be part of the group using the conduit structure, but it could also be an unrelated company which carries on a separate business, such as a bank.

If the deductible outgoing payments are genuine business expenses, there is nothing artificial or abusive about the arrangement. Many large multinational groups of companies, for example, establish a company within the group to carry out a treasury function. Such a treasury company acts, in essence, as a private bank for the whole group. Often, some group companies have excess liquidity, whereas others need funding, and it is more efficient for the group as a whole to manage the flow of finance internally, rather than go to an external bank. If the treasury company is genuinely the “nerve centre” that regulates these flows of finance, both the company itself and the income flows in and out of the company have a business purpose. Similar considerations apply to a group company that manages the licensing of patents and trademarks and the resulting flows of royalties within the group.

The essence of a conduit structure, on the other hand, is that the incoming and outgoing payments are part of an artificial arrangement designed to achieve the result, in legal terms, that the incoming payments belong to the conduit company and therefore fall within the treaty entitlement of the conduit company. A consideration of the object and purpose of the treaty leads to the conclusion, however, that due to the base erosion there is not enough double taxation of the incoming payment to justify granting treaty protection for it.

The effectiveness of the beneficial ownership requirement in combatting these structures depends on various factors. The closer the match between the incoming and outgoing payments, the stronger the argument is that the conduit company is not the beneficial owner of the incoming payments. But if the outgoing payments are arranged to be quite different in composition, payment dates, etc., it may be difficult to argue that the conduit company is not the beneficial owner of the incoming payments. The tax authority of the source State also has the additional difficulty of discovering enough of the facts to contest the claim to treaty benefits. If the conduit structure does, for example, flow through an unrelated bank, the tax authority of the source State may have to examine the complete books of the bank in order to discover the structure, which is not an easy task if it is a large commercial bank with thousands of genuine clients.

Here again, a strong exchange of information network is essential. What may also help are treaty provisions that provide a basis for

the investigation by the source State. A provision, for example, that excludes the application of the treaty to back-to-back arrangements does not automatically prevent the granting of treaty benefits to abusive conduit structures, but it does provide the source State with a basis on which to ask pertinent questions. The source State may further require the company claiming treaty benefits to provide its tax identification number (TIN) in its residence State, which would alert the company to the possibility that information about the income may be provided to that State. And the source State may require the company to certify that it is the beneficial owner of the income for which treaty benefits are claimed; such a requirement does not guarantee that the claim is well founded, but it does have a certain deterrent effect against unjustified claims.<sup>41</sup>

If the incoming payment of the conduit company is not a dividend, interest or a royalty, the United Nations and OECD Model Conventions do not apply the beneficial ownership requirement. Countries that are concerned about conduit structures outside the reach of Articles 10, 11 and 12 may therefore wish to consider anti-abuse provisions that apply to all the allocation articles. Alternatively, in this case it may be possible to apply parallel reasoning to argue that the income is not “derived by” the conduit company.

## **6. Special cases**

### **6.1 Exempt entities (pension funds)**

Exempt entities have already been discussed in section 3 above, in connection with the second step in determining entitlement to treaty benefits, namely the residence requirement. Pension funds are discussed further here as an illustration of some further policy considerations which may apply.

In many States, pension funds are exempt from tax on their income, provided they comply with the extensive regulations to which

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<sup>41</sup>Model forms for making this certification have been developed by the OECD in the context of the Treaty Relief and Compliance Enhancement (TRACE) — Implementation Package (see *supra* footnote 10).

they are usually subject. The exemption is generally granted to the pension fund as such, raising the issue of whether the fund is “liable to tax” in the State in which it is established and therefore a resident of that State for treaty purposes.

Policy considerations, however, usually do demand that a pension fund is able to enjoy the benefit of the treaties concluded by the State in which it is established. An individual who invests his money directly in the source State would usually be entitled to treaty benefits and it would be inconsistent to deny treaty benefits because the investment is made indirectly through a pension fund. Furthermore, pension funds need to spread their investments geographically. Therefore, it is often in the interests of both contracting States to prevent their tax systems from discouraging investments by pension funds of the other State.

All these considerations argue towards regarding a pension fund as a resident of the State in which it is established, despite its personal exemption from tax. One way in which this can be achieved is by accepting that a pension fund is indeed “liable to tax” because it is within the scope of the income tax law and its exemption is dependent on complying with the applicable regulatory requirements. Some States, however, feel unable to accept this line of reasoning and in this case it would be necessary to come to an explicit agreement with the other contracting State about the treaty status of pension funds, either in the treaty itself or in a mutual agreement.

## 6.2 Partnerships

Partnerships raise two sets of questions in connection with entitlement to treaty benefits which are discussed here.<sup>42</sup> One set of questions concerns the first and second steps discussed above in determining entitlement to treaty benefits; the issues here are whether a partnership is a “person” capable of claiming treaty benefits and being a resident of a contracting State for treaty purposes. The second set of questions

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<sup>42</sup>The report published by the OECD in 1999 on the application of tax treaties to partnerships examines these issues in more detail: see *The Application of the OECD Model Convention to Partnerships*, adopted by the OECD Committee on Fiscal Affairs on 20 January 1999 (OECD Partnership Report).

focuses on which person is entitled to treaty benefits in respect of income derived by a partnership; is it the partnership or the partners? Or is it possible that more than one person is entitled to treaty benefits, or maybe no person at all? Other issues, such as the characterization of distributions made by a partnership to its partners, are not directly relevant to the initial issue of treaty entitlement and are therefore not covered here.

The answers to the first set of questions are now relatively clear; the definition of “person” in Article 3 (1) includes a “body of persons” and there is international agreement that a partnership is a “body of persons”. The Commentaries on Article 3 of both the United Nations and OECD Model Conventions state that partnerships are persons for treaty purposes, either because they are taxed as companies or because they are bodies of persons.<sup>43</sup> In many States, partnerships are taxable as such and, if that is the case, it would be rather inconsistent to argue that they are not “persons” for treaty purposes, given that the aim of treaties in this respect is to deal with the conflicting taxing claims actually made by States.

There is also general agreement that a partnership is capable of being a resident of a State for treaty purposes, provided it is the partnership as such that is liable to tax in that State. This is, however, only one of three possible approaches in domestic law to the taxation of partnership income. A second approach is to require the profit to be computed at the level of the partnership, but to apportion the profit out among the partners and tax the appropriate share of profit in the hands of each partner separately. The third approach is to ignore the partnership altogether for tax purposes and attribute all of the partnership’s receipts, assets, expenses and liabilities to the separate partners, requiring each partner to make a profit computation as if the partner carried on a separate business. In the latter two cases, it is not the partnership that is liable to tax on the partnership income, but the partners who are liable to tax on their share of the profit or income and, therefore, the partnership would not qualify as a resident for treaty purposes.

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<sup>43</sup>Paragraph 4 of the Commentary on Article 3 of the United Nations Model Convention; Paragraph 2 of the Commentary on Article 3 of the OECD Model Convention.

Much more difficult, however, is the set of questions that arises when countries take different approaches to the taxation of partnerships. The possible mismatches in this respect are not confined to the relationship between the source State of the income and the State in which a partnership is established; a partnership established in one country may have partners who are resident in a different country, considerably increasing the scope for mismatches of domestic law. These mismatches can cause double taxation as between the residence States of a partner and the partnership. Alternatively, they can lead to there being no residence-based taxation at all. For the source State of partnership income, the question is what the implications are of these mismatches for the application of any treaties it has concluded with one or more residence States.

Neither the United Nations nor the OECD Model Convention deals explicitly with partners and partnerships, although an increasing number of concluded treaties do. But the Commentaries on both Model Conventions do include discussion of these issues, drawing on the work of the OECD in this respect.<sup>44</sup> The solutions adopted by the OECD do not, however, find universal acceptance among the members of the United Nations Committee of Experts on International Cooperation in Tax Matters.<sup>45</sup>

The solution proposed by the OECD to the problem of domestic law mismatches is that the source State looks at both the residence State of the partnership and the residence State (or States) of the partners. Any of those persons who is liable to tax in respect of the partnership income is potentially entitled to treaty benefits. This means that it is possible for the partnership to be entitled to the benefit of the treaty between its residence State and the source State in respect of partnership income and for one or more partners to be entitled, at the same time, to the benefit of the treaty between their residence State and the source State in respect of their share of the partnership profit or income. The reverse situation is also possible, that neither the

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<sup>44</sup>See *supra* footnote 42.

<sup>45</sup>Paragraph 6 of the Commentary on Article 4 of the United Nations Model Convention records the disagreement of some members with the proposition in paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention that partners of fiscally transparent partnerships can claim treaty benefits in respect of income derived by the partnership.

partnership nor the partners are entitled to treaty benefits because none of them is liable to tax in respect of any part of the partnership income. It should be noted that that this solution looks at liability to tax as an indication of which person is entitled to treaty benefits in respect of which item of income, or in other words, in connection with the third step discussed above in the determination of entitlement to treaty benefits.<sup>46</sup>

This solution accords with the philosophy that treaties are intended to deal with double taxation caused by the imposition of tax by both contracting States. The assumption is that the source State wishes to tax the income in question, otherwise it would not have to consider applying a treaty. The advantage of the OECD solution is that a treaty applies when the imposition of tax liability by a residence State poses an actual threat of double taxation but that no treaty applies when there is no such threat. On the other hand, some countries find it a disadvantage that the source State's approach to the taxation of partnership income is not relevant in determining whether treaty protection is available. This solution also means that a source State dealing with partnership income has to be aware of the domestic law of the residence State of the partnership and/or partners who are claiming treaty protection. The source State could, however, require those persons to provide sufficient information about that domestic law to substantiate their claim.

### **6.3. Transparent/hybrid entities and corporate group regimes**

The terms “transparent entity”, or “flow-through entity”, as they are sometimes called, are not exact terms; here, either term is used to describe an entity, usually a company, which is clearly a legal person but which is ignored for tax purposes in the country in which it is established. The income of the entity is, instead, attributed to the owners or shareholders and taxed in their hands as if they received it directly. Such rules are usually specific to the country in which the entity is established; if the entity receives income from another country,

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<sup>46</sup>Paragraphs 54, 61, 71 and 73 of the OECD Partnership Report also conclude that a partnership or partner that is liable to tax in respect of dividends, interest or royalties is the beneficial owner of the income.

the source State very often regards the entity as the taxable person in respect of that income. There is therefore a mismatch between the two countries as to which person they regard as the taxable person. The term “hybrid entity” is often used to describe the entity in such a case.<sup>47</sup>

Although there are similarities between hybrid entities and partnerships, there is also a significant difference. The different approaches to partnerships stem from different domestic law concepts as to what constitutes a person for tax purposes. In the case of a hybrid entity, however, both States start from the position that the entity is a legal person and therefore a taxable person under the general tax law. The different approaches arise because one State applies a deeming rule attributing the income to the entity’s owners/shareholders whereas the other State does not.

In this situation, it might be more difficult for the source State to accept the tax treatment in the entity’s State of establishment as a basis for granting treaty benefits. The consequence may well be a technical difficulty in applying a treaty between the two States. The entity is not “liable to tax” in the State in which it is established and, therefore, it does not qualify as a resident for treaty purposes. The owner/shareholder, on the other hand, generally does qualify as a resident of that State (transparent tax regimes often apply only if the owners/shareholders are resident in the State in which the entity is established), but it is not the owner of the income and, therefore, it does not satisfy the third step, discussed above, for claiming treaty benefits in respect of that income.

Exactly this problem arose in the TDS case, decided in Canada in 2010.<sup>48</sup> This case concerned a company, TD Securities (TDS), which was incorporated in the United States of America. TDS was treated as a transparent entity in the United States and all its income was taxable in the hands of its 100 per cent shareholder, a United States resident company for treaty purposes. TDS claimed treaty benefits in respect of the profit it earned through its permanent establishment in Canada.

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<sup>47</sup>This is also not an exact term. Both the terms “transparent entity” and “hybrid entity” are also used to describe partnerships and other legal structures which are ignored for tax purposes or which are the subject of recognition mismatches in domestic law.

<sup>48</sup>*TD Securities (USA) LLC v Her Majesty the Queen*, 2010 TCC 186.

The court found that the technical problem described above could indeed prevent the application of the treaty, but it adopted a broad, purposive interpretation of the treaty and granted treaty protection. From a policy point of view, this decision is easily defensible, as the profit in question both belonged to a company with a personal connection with the United States and was taxed in the hands of a company with a personal connection with the United States. Nevertheless, the technical obstacle in a case such as this remains in the United Nations and OECD Model Conventions. In practice, the residence State may not be willing to grant a residence certificate to the subsidiary, but only to the parent company, and some source States would find it difficult to grant treaty benefits when faced with a mismatch between the residence certificate and the person who owns the income.

Similar difficulties can arise in respect of corporate group regimes. The most integrated type of group regime also, in essence, turns the subsidiaries within the group into transparent entities as it treats them as branches of the top company. The subsidiaries within the group could therefore encounter the same difficulties in claiming treaty benefits.

A group regime with a less extreme form of integration may, on the other hand, avoid these problems if the mechanism of the regime is to compute profit in the hands of each group company separately but tax the profit in the hands of the top company. In this case, there is an argument that the subsidiaries are liable to tax and are residents for treaty purposes. They are not ignored by the tax law and, therefore, they are liable to tax, although they are not subject to tax for as long as they remain within the group regime. Their position is, in other words, comparable with persons such as charitable foundations which enjoy a personal exemption; they are within the scope of the tax law, but they do not have a positive tax liability provided they continue to comply with certain conditions.

## **6.4 Trusts and trustees**

Trusts are notorious for the problems that they cause in the application of tax treaties. They are equally notorious for being regarded as an essential feature of the legal landscape in many (common law) States, whereas other (civil law) States often regard them with a large degree of suspicion. Finding some common ground between these two points

of view adds a further layer of difficulty to an already difficult task of determining how to apply a treaty to trust income.

The United Nations Model Convention deals explicitly with trusts only in Article 13, in connection with capital gains from immovable property that are realised indirectly through an intermediate vehicle, such as a company, partnership or trust.<sup>49</sup> Subject to this one provision, neither the United Nations Model Convention nor the OECD Model Convention deals explicitly with income derived by trusts. Many concluded treaties have some provisions on trusts, but there are extremely few concluded treaties, if any, which provide a comprehensive set of rules for dealing with them. This is so, even though a substantial amount of wealth is held in trusts in many countries.

It is impossible to consider the application of treaties to trusts without a good understanding of the trust concept. This section therefore starts by explaining the basic features of a trust. The trust concept has been adopted statutorily by an increasing number of civil-law jurisdictions, but these statutory adaptations follow the original judge-made concept with varying degrees of strictness. The discussion here, therefore, is confined to the major common law jurisdictions. It then goes on to sketch the various ways in which trust income is taxed in the major common law countries, as this is an equally important ingredient in understanding the treaty issues. Finally, the two most acute issues in connection with the application of treaties to trusts are examined.

Two common uses of trusts are as collective investment vehicles (CIVs) and real estate investment trusts (REITs). These types of trust raise specific issues which have been investigated by the OECD<sup>50</sup> and which are not discussed here.

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<sup>49</sup>Paragraph 28.5 of the Commentary on Article 13 of the OECD Model Convention suggests a comparable provision.

<sup>50</sup>*The Granting of Treaty Benefits with respect to Collective Investment Vehicles*, report adopted by the OECD Committee on Fiscal Affairs on 23 April 2010, available at <http://www.oecd.org/tax/treaties/45359261.pdf>; *Tax treaty issues related to REITS*, discussion draft published on 30 October 2007, available at <http://www.oecd.org/tax/treaties/39554788.pdf>. Many of the conclusions drawn in these documents have been added to the Commentaries on the OECD Model Convention.

### 6.4.1 The trust concept

An extremely important point to be made at the outset is that trusts are not legal persons or entities that are separate from the parties involved in the trust. Although it is very common to talk about trusts as if they were an entity,<sup>51</sup> this manner of speaking is simply a shorthand way of referring to the trust relationship. And it is the relationship between the trustees and the beneficiaries that is the essence of the trust concept.

A trust is an arrangement in which trustees own assets in a fiduciary capacity for the benefit of the beneficiaries. An alternative way of describing a trust is that it is an asset-holding and management structure, in which trustees own, invest and maintain the trust assets and collect the income from those assets, all for the benefit of the beneficiaries. The fiduciary nature of the arrangement requires trustees to put the interests of the beneficiaries before their own interests. Trusts are often discussed as if the beneficiaries are necessarily individuals, but it is equally possible for the beneficiaries to be companies or other legal entities and many trusts are established for purely commercial purposes.

One of the features of the trust relationship that causes problems for a tax system is that they are extremely flexible instruments. The interests of the beneficiaries can be defined in any way that appeals to the settlor or grantor (the person who creates the trust), the only restriction usually being that the terms of the trust may not be contrary to public policy (by being racially discriminatory, for example). It is, therefore, difficult to define neat categories of beneficial interests for tax purposes.

Nevertheless, there is one distinction that can be drawn in respect of different beneficial interests which is important for income tax purposes, namely, the difference between trusts in which a beneficiary has an immediate right to the income of the trust and trusts in which this is not the case. A single trust does not necessarily fall entirely into one or the other category; it is possible for a trust to be in

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<sup>51</sup>In some countries, such as Canada and the United States, trusts are deemed to be persons for the purposes of the tax law.

one category in respect of part of its income and in the other category in respect of the remainder of its income.

The first category of trusts gives one or more beneficiaries the right to receive the income of the trust as the income arises. This right might be limited, for example, to a fixed period or to the lifetime of the beneficiary but the important point is that, for as long as that right exists, the trustees are obliged to distribute that income to the beneficiary as soon as it arises. In this situation, the collection of the income by the trustees is nothing more than an inconvenient administrative detour, and therefore the trustees sometimes request the source of the income to pay it directly to the beneficiary. A common example of this type of trust in a family situation is one set up in the will of a deceased individual, in which the spouse of the deceased individual is entitled to the income from the trust assets for his/her lifetime.<sup>52</sup>

The second category of trust is one in which there is no beneficiary who can claim the income as it arises. This could be because the trustees are obliged to accumulate the income and distribute it at a later date, possibly a very much later date, as capital. Alternatively, the trustees may have a discretion as to whether to distribute income to a beneficiary and, if so, how much income to distribute, when to distribute it and which beneficiary to distribute it to. This type of trust has a class of beneficiaries, which may be rather large, although there generally has to be some limitation on the members of the class.<sup>53</sup>

The first category of trust is often called a fixed trust, and the second category is often called an accumulation trust or a discretionary trust. These terms are, however, nothing more than convenient labels to describe a type of trust that is commonly found. In any given case it is essential to study the terms of the trust carefully, as it is the trust terms that are the definitive source of information about the rights of the beneficiaries.

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<sup>52</sup>Often the children of the couple receive the trust assets on the death of the surviving spouse.

<sup>53</sup>In many countries, it is either not possible to create what is known as a purpose trust, or in other words a trust with no beneficiaries, or this is possible only in limited circumstances, for example if the trust has a charitable purpose.

### 6.4.2 Domestic taxation of trust income

Although the trust concept is well known in most common law countries, it is not true that the tax system of these states is automatically able to accommodate trusts. Quite the contrary, in fact; the tax law of these jurisdictions often has to be made to apply to trusts, usually resulting in a large quantity of legislation devoted to them. It should be emphasized that all the information about the taxation of trusts that is provided here is of a highly generic nature and subject to a large degree of generalisation. In any given case it is essential to study the relevant tax law carefully, especially as the taxation of trust income is characterised in most common law countries by a great deal of complexity and sometimes also inconsistency.

The general aim of the income tax system in common law countries is to tax trust income at the rates that are applicable to the beneficiaries, as they are the persons who enjoy the benefit of the income. Although the detail differs, these countries generally reach this result in two cases: if the beneficiary is entitled to the income as it arises to the trust; or if the income is actually distributed to the beneficiary on the exercise of their discretion to do so by the trustees.

This overall policy aim in these cases is clear, but common law States have found many different ways of achieving it. One possibility is simply to tax the beneficiary on the trust income as it arises and ignore the trustee. A second possibility is to impose a tax charge on the trustee as a representative of the beneficiary; in this case the tax is computed taking into account the personal circumstances of the beneficiary, but the liability to pay the tax is imposed on the trustee. A third possibility is to tax both the trustee<sup>54</sup> in respect of the trust income and the beneficiaries in respect of income they receive from the trust, but to provide a mechanism to prevent the resulting economic double taxation of the income flow. One mechanism is to allow the trustees to deduct income distributions to beneficiaries from the trust income, and another is to grant the beneficiaries a credit for the tax paid by the trustees. All of these systems are in use and some countries use different mechanisms in different circumstances.

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<sup>54</sup>Or the trust, in countries which deem trusts to be persons for tax purposes.

If, however, the trust income is accumulated and capitalised by the trustees, there never is a beneficiary that receives the income. At some point the trustees will distribute it to a beneficiary,<sup>55</sup> but by that time it will be a distribution of capital.<sup>56</sup> In this situation, the only way to tax the trust income is in the hands of the trustees.

There is another possibility that is found in most common law countries, namely that the trust income is taxed in the hands of the settlor/grantor. The settlor/grantor is not necessary for the operation of a trust once it has been established; once he has provided the assets subject to the trust and set out its terms the trust is fully created. The settlor/grantor is not a party to the trust relationship, as it is the trustees who are responsible for administering the trust and the beneficiaries who have the right to enforce the trust. Nevertheless, one of the aspects of the flexibility of the trust concept is that it is possible for a settlor/grantor to reserve for himself various powers, such as the power to direct the trustees or the power to change the beneficial interests in the trust.<sup>57</sup>

Most common law states have some legislation which taxes trust income in the hands of a settlor or grantor who has reserved certain powers in this way. These rules commonly tax trust income in the hands of a settlor/grantor, even though he does not receive the income and does not benefit from it in any way or only in an extremely indirect way. A very common rule is that trust income is taxed in the hands of a settlor/grantor who has reserved the power to revoke the trust, but outside this situation the circumstances in which the settlor/grantor is

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<sup>55</sup>Most common law countries have what is known as the rule against perpetuities; this rule prevents attempts to tie up capital in a trust for excessively long periods of time by imposing certain limits on the duration of a trust. Nevertheless, it is often possible for trusts to exist for periods of roughly 100 years. Eventually, however, the trust has to be wound up and the assets distributed to the beneficiaries at that time.

<sup>56</sup>Which may well have consequences for gift, estate or inheritance tax, if the country has such a tax, but this tax charge is not relevant to the application of an income tax treaty.

<sup>57</sup>It is also possible for the trust terms to give comparable powers to a person who is not the settlor/grantor, in which case that person is often the taxable person.

the taxable person vary a great deal from one country to another. In many countries, these rules are regarded as anti-avoidance rules, but in the United States, for example, they are regarded as an integral part of the trust taxation system rather than an anti-avoidance measure.

#### **6.4.3 Application of treaties to trust income**

Unfortunately, there is little case law and little available guidance on the application of treaties to trust income. Furthermore, the variety of domestic systems for taxing trust income makes it difficult to distil general principles in this respect. The primary difficulty is the third step in determining entitlement to treaty benefits, the issue of which person is entitled to claim treaty protection in respect of which kind of income. In connection with trustees, there are also some issues in respect of the second step, which are discussed in the following section.

There is one situation in which the application of a treaty is relatively easy. If a beneficiary is entitled to trust income as it arises, or actually receives specific trust income that is distributed at the discretion of the trustees, and the beneficiary is the only taxable person in respect of the income, it is rather obvious that the beneficiary should be the person who is potentially entitled to treaty benefits in respect of the income.

At the other end of the scale, in situations in which the trustees are the only persons who are taxable in respect of trust income, it may seem equally obvious at first sight that they are the persons who are potentially entitled to treaty benefits in respect of the income. Some countries, however, find it difficult to accept that trustees can claim treaty benefits because trustees, by definition, do not receive the income on their own behalf. Their position is a fiduciary one; they always receive the income for the ultimate benefit of the beneficiaries, even if the income does not reach the beneficiaries until after it has been accumulated and capitalised. In respect of dividends, interest and royalties, therefore, the argument is that the trustees cannot be the beneficial owners.

The danger with this objection is that it might prevent a treaty from being applied, even though the income in question clearly has a substantial economic connection with a treaty partner State because it

is paid to trustees in that partner State for the benefit of beneficiaries resident in that same State. One solution is to accept that the management functions of trustees in respect of the income are sufficient for the trustees to qualify as beneficial owners for treaty purposes.<sup>58</sup> Another solution is to provide in the treaty that treaty benefits are available to trustees if all the beneficiaries are resident in the same State, but there is an obvious limitation on the effectiveness of this solution if even one beneficiary is resident elsewhere. A proportional approach, which would grant treaty benefits to the extent that the beneficiaries are resident in the same State, suffers from the difficulty that it may be extremely hard, or even impossible, to determine the appropriate portion at the time that the trust income is received.<sup>59</sup>

If trust income is subject to one of the other income tax regimes described in the previous section, and in the absence of specific rules in the treaty, there are many unanswered questions as to how a treaty should apply. The issue of which person is the right person to claim treaty benefits is particularly difficult. A complicating factor in this respect is that a further distinction can also be made among domestic systems in their characterisation of income distributed to beneficiaries.

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<sup>58</sup>For example, most of the treaties concluded by New Zealand state explicitly that, if trustees are taxable in respect of trust dividends, interest and royalties, they are also regarded as the beneficial owner of the income for treaty purposes. The New Zealand domestic system of taxing trust income taxes either the trustee or the beneficiary as the income arises, depending on whether or not a beneficiary is entitled to the income or actually receives a distribution of the income.

<sup>59</sup>A proportional approach would have to be based not on simple numbers of beneficiaries, but on the size of the entitlements of the beneficiaries. If the trustees have a discretion to decide which distributions to make and to which beneficiaries, those decisions may not be made until long after the trust income is received. The distributions may also be very different in nature. For example, one beneficiary might receive a capital sum, whereas another beneficiary might receive an entitlement to income, and the distributions might be made at different times. A further complication is that at the time that the trust income is received by the trustees they might not even know who all the beneficiaries are; in many family trusts, the class of beneficiaries includes children who are born after the trust is established and some of them may not have been born when the trust income is received.

In some cases, the income received by the beneficiary has the same characterisation as the income received by the trustees; in these cases it is easier to regard the beneficiary as the person potentially entitled to treaty benefits.<sup>60</sup> In other cases, however, the income received by the trustees becomes part of a general pool of trust income and, if it is distributed to a beneficiary, it has a different characterisation, such as an annuity. In this case, it is much more difficult to trace the income from a source State through to a beneficiary and, here again, it may be that the only solution is to regard the trustees as the persons potentially entitled to treaty benefits.

If passive trust income is taxable in the hands of a settlor/grantor,<sup>61</sup> nevertheless, it is probably the trustees or the beneficiaries who are the persons potentially entitled to claim treaty protection in respect of the income. The conditions for treaty entitlement are that the claimant is a person, that the person is resident in a contracting State and that the claimant has the required ownership connection with the income in question, such as beneficial ownership in the case of dividends, interest and royalties. The settlor/grantor may well satisfy the first two conditions, but it would often be difficult to argue that he is the beneficial owner of the income if he does not receive any direct benefit from the income.<sup>62</sup> An important exception to this general statement concerns treaties concluded by the United States, which generally include a provision treating the grantor as the person potentially entitled to treaty benefits to the extent that the grantor is taxable in respect of the trust income.<sup>63</sup>

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<sup>60</sup>One of the possible problems here, however, is that this might be the case even though the distribution to the beneficiary is made a long time after the income was received by the trustees. Tracing the income through to the beneficiary might mean, therefore, that a treaty could not be applied until long after the income was paid.

<sup>61</sup>Or another person who has powers in respect of the trust.

<sup>62</sup>Unless one understands the beneficial ownership requirement to refer to the person who is liable to tax in respect of income, which is one of the possible meanings that has been advanced.

<sup>63</sup>Article 1 (6) of the United States Model Income Tax Convention of November 15, 2006 and the Model Technical Explanation accompanying it.

#### 6.4.4 Residence of trustees

A second set of problems arises in connection with the second step in determining entitlement to treaty benefits, namely, the residence of trustees for treaty purposes.<sup>64</sup> This issue arises, of course, only if it is decided that the trustees are the correct persons to claim the benefit of a treaty.

Although it is possible for a trust to have only one trustee, many trusts have two or more. The trustees of a single trust are generally accepted to constitute a “body of persons” and are therefore capable of being a person for treaty purposes. In countries that recognize the trust concept, a body of trustees is almost always capable of bearing a tax liability and, therefore, the body of trustees is also capable of being a resident of a contracting State for treaty purposes.

Determining the State in which a body of trustees is resident is, however, a much more difficult issue. The case law in common law countries is not consistent in this respect. Some case law looks at the personal residence of the companies or individuals who fulfil the role of trustee, but there is an obvious problem with this approach if the trustees have their personal residence in different States. Furthermore, the relevance of the trustees’ personal residence is not immediately obvious as the trustees do not necessarily carry out their trustee activities in their personal residence State.

From a policy point of view, the preferable choice is the place where the management of the trust is carried out. This view seems to be gaining acceptance, although it is by no means universally adopted. In a Canadian case decided in 2012, for example,<sup>65</sup> the court held explicitly that, given the asset management functions of a trust, it was similar in this respect to a company and the correct test was the place where those management functions were carried out. Recent guidance from the United Kingdom of Great Britain and Northern Ireland tax authority<sup>66</sup> also focuses on the place where the trust is managed.

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<sup>64</sup>Or a trust, in respect of countries which deem trusts to be persons for tax purposes.

<sup>65</sup>*St. Michael Trust Corp., as Trustee of the Fundy Settlement v Her Majesty The Queen*, 2012 SCC 14.

<sup>66</sup>HMRC Trustee residence Guidance, available at <http://www.hmrc.gov.uk/manuals/tsemmanual/index.htm>.

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## Chapter III

### Taxation of residents on foreign source income

PETER A. HARRIS\*

The prescriptive rules in tax treaties for taxation of foreign source income in the residence country are more limited than those that apply to restrict source country taxing rights. This is despite the fact that the acknowledged purposes of tax treaties (elimination of double taxation and prevention of fiscal evasion) have equal relevance for both source and residence countries. The comparative lack of prescriptive rules has an important impact on the manner in which the taxation of foreign source income is administered in residence countries, with heavy reliance on domestic tax rules.

The first matter this chapter looks at is the manner in which tax treaties can have an impact on the administration of taxation in the residence country. The primary effect is an obligation to eliminate double taxation of foreign source income of residents, and a number of provisions of tax treaties may be relevant in this regard. Often, less obvious is the subtle manner in which tax treaties interact with anti-abuse rules, whether the anti-abuse rules are of a specific or general nature. Having identified the relevant provisions in tax treaties and their potential scope, the chapter then considers, in turn, the administrative mechanics of these two issues, that is to say, elimination of double taxation with respect to and application of anti-abuse rules to foreign source income. The final section considers the effect of deriving foreign source income on general tax administration issues, with a particular focus on collection of information, proof of foreign income and foreign tax, and time limits.

#### 1. Impact of tax treaties and elimination of double taxation

Both the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model

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Convention)<sup>1</sup> and the Organisation for Economic Cooperation and Development Model Tax Convention on Income and on Capital<sup>2</sup> (OECD Model Convention) recognize the dual main purposes of tax treaties as the elimination of double taxation and the prevention of fiscal evasion.<sup>3</sup> Both these purposes of tax treaties are important in the taxation of foreign source income of residents. The manner in which these purposes may have an impact on such taxation requires an understanding of who are residents and when income is considered as having a foreign source. The first of these is critical in the application of tax treaties. As a general rule, tax treaties only apply to “persons” (as defined) who are “residents” of a contracting State (Article 1).<sup>4</sup> That application, entitlement to treaty benefits and the definition of “resident” (Article 4) are dealt with in another chapter<sup>5</sup> and are not further explored here.

## **1.1 Source of income must be determined by general principles**

As for the source of income, generally tax treaties do not contain many express source rules. Rather, they grant taxing rights to certain countries on the bases specified in the various articles of the tax treaty and,

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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

<sup>2</sup>Organisation for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

<sup>3</sup>OECD Model Convention, Title of Convention, footnote 1, and the United Nations Model Convention, Title of Convention, footnote 1. See also, for example, paragraphs 3 and 16 of the Introduction to the OECD Model Convention; paragraph 12 of the Commentary on Article 10 of the OECD Model Convention, reproduced in paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention. However, paragraph 3 of the Introduction to the OECD Model Convention still suggests that “the main purpose of the OECD Model” is to settle “problems that arise in the field of international juridical double taxation.”

<sup>4</sup>Unless specified otherwise, references to Articles in this chapter are references to the Articles of the United Nations and OECD Model Conventions.

<sup>5</sup>See Chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler.

in particular, the distributive rules in Articles 6 through 21. In most cases, though not all, an express taxing right of the residence country is referred to.

These distributive rules of tax treaties also grant taxing rights to the contracting State that is not the residence country, for the purposes of this chapter referred to as the “source country”. It is, perhaps, accurate to say that when a treaty grants a source country a right to tax, the source of the income is located in that country. However, it is not accurate to suggest that the right of a source country to tax under tax treaties represents a comprehensive set of rules for determining the source of income. Consistent with the purpose of tax treaties in eliminating double taxation and as a mechanism for allocating taxing rights between countries, tax treaties limit the rights of source countries to tax income that may, according to general principles, be considered to be sourced in that country. So there are many circumstances in which income may be considered to have a source in a particular country, but that country is not granted a taxing right under tax treaties.

Consequently, for the purposes of this chapter, “foreign source income” with respect to a country is taken to mean income that according to general principles does not have a source in that country. Foreign source income includes, but is not limited to, income that may be taxed under a treaty by a treaty partner on a basis other than residence of the person deriving the income. Further, “foreign source income” may be, according to general principles, considered sourced in a treaty partner or sourced in some third country. In the latter case it is referred to as “third country income”. This analysis is not intended to suggest that there is general agreement on how to locate source according to general principles, but that is not something regulated by tax treaties. It is, however, something that must be regulated by domestic law, explored further below.

## **1.2 Tax treaties do not limit the scope of a residence country’s right to tax foreign income**

While tax treaties limit source country taxing rights, a more difficult question is whether the distributive provisions of tax treaties represent any restriction on a residence country’s right to tax. The preferred view seems to be that the distributive rules in Articles 6 to 21 are not

intended to directly limit residence country taxing rights,<sup>6</sup> although, as pointed out below, this may happen indirectly and particularly under other provisions of tax treaties. It seems that any reference to residence country taxing rights in the distributive rules of tax treaties is often used as a method of limiting source country taxing rights. This is particularly the case where the distributive rules say that certain income “shall be taxable only” in the residence country, with specific exceptions where the source country is granted a right to tax.<sup>7</sup>

Less clear is whether the reference to residence country taxing rights in the cases of Article 10 (Dividends), Article 11 (Interest) and Article 12 (Royalties, United Nations Model Convention only) may be considered simply as a mechanism for limiting source country taxing rights. These provisions say that the residence country “may” tax and go on to symmetrically refer to situations when the source country “may also” tax. A difficulty is in determining the scope of these provisions because they only refer to dividends, interest or royalties “paid” by a resident of a contracting State to a resident of the other contracting State.<sup>8</sup> It is generally accepted that these rules do not

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<sup>6</sup>Article 19 (Government service) of both the United Nations and OECD Model Conventions is an exception. This provision is intended to directly limit residence country taxing rights.

<sup>7</sup>For example, this is the approach in Article 7 (Business profits), Article 8 (Shipping, inland waterways transport and air transport, although using a proxy test of residence), Article 12 (Royalties, OECD Model Convention, but not the United Nations Model Convention), Article 13 (Capital gains), Article 14 (Independent personal services, United Nations Model Convention), Article 15 (Dependent personal services), Article 18 (Pensions and social security payments), Article 19 (Government service) and Article 21 (Other income). Analysis of Article 20 (Students), which specifies a contracting State in which certain income “shall not be taxed”, is more complex. See also paragraph 6 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>8</sup>Articles 11 (5) (of both the United Nations and OECD Model Conventions) and 12 (5) (United Nations Model Convention only) extend the scope of the Articles on interest and royalties to interest and royalties “borne” by a permanent establishment or fixed base (United Nations Model Convention only) in one contracting State and “paid” to a resident of the other contracting State. Under these extending source rules, the residence of the “payer” is irrelevant.

limit a residence country's right to tax dividends, interest and royalties, either when paid or in other circumstances, for example, as they accrue or deemed payments of this type. By contrast, it is generally (although not universally) accepted that these rules do limit source country taxing rights, that is to say, the source country may tax only when these items are "paid".

Part of the problem is that the scope of Articles 10, 11 and 12 is not specified. If the reference to "paid" and the "payer" being a resident of a contracting State determines the scope of the provisions, then those provisions would not deal with any other amounts that may be described as dividends, interest or royalties. These other amounts would fall residually into Article 21 (Other income) or, perhaps, Article 13 (Capital gains). Under the OECD Model Convention, this would mean that, as a general rule, the income would be "taxable only" in the residence country. By contrast, if the income falls under Article 21 of the United Nations Model Convention, the source country (country in which the income "arises") is granted an unlimited right to tax.<sup>9</sup> In any case, the preferred view is that Articles 10, 11 and 12 do not limit a residence country's right to tax.

The same also seems true of other distributive rules that do not refer to a residence country's right to tax. Article 6 (Income from immovable property), Article 16 (Directors' fees and remuneration of top-level managerial officials) and Article 17 (Artistes and sportspersons) grant no express right to tax to residence countries. However, they also impose no limitation on the right of residence countries to tax and it is accepted that the residence country's inherent right to tax income covered by these Articles is not affected. Indeed, the residence country's obligation to eliminate double taxation (Article 23) presumes that the residence country has a right to tax any income that may be taxed by the source country. The distributive rules of tax treaties do not force a source country to tax even if the source country has an unlimited right to tax. Similarly, such rules do not require that a residence country impose tax on foreign source income of its residents. The general principle that tax treaties do not impose tax applies equally to residence countries as it does to source countries.

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<sup>9</sup>This is by reason of Article 21 (3) of the United Nations Model Convention. This unlimited right to tax can be contrasted with the limited right of the source country to tax under Articles 10, 11 and 12.

### **1.3 Tax treaty limitations on the manner in which residence country taxes**

While tax treaties may not prevent a residence country from taxing foreign source income of its residents, they do impose other obligations as to the manner in which that tax may be imposed. Tax treaties contain many rules that affect the manner in which source countries calculate income and the tax rate that they may impose on the income. This is not true of residence countries, where there are few rules relating to the manner in which foreign source income should be calculated and the rate of tax that may be imposed with respect to that income. After those rules are considered, the focus turns to the main tax treaty obligation imposed on residence countries—the obligation to eliminate double taxation.

#### **1.3.1 Non-discrimination**

The non-discrimination rules in tax treaties (Article 24) contain important (though not comprehensive) limitations on the taxing rights of contracting States. While these rules are, perhaps, primarily targeted at source countries or countries hosting foreign investment, there are cases in which they can apply to residence countries. In particular, if the resident person in question is a national of the other contracting State, the residence country cannot subject that person to more burdensome taxation than its own nationals who are also resident.<sup>10</sup> Similarly, a residence country cannot subject a resident entity conducting a business to more burdensome taxation by reason that the entity is owned or controlled by residents of the other contracting State.<sup>11</sup> While this provision has important application where income is sourced in the residence country, it can also apply to the taxation of foreign source income (including third country income) and, in particular, the application of unilateral foreign tax relief (discussed below).

By contrast, Article 24 (4) prevents a residence country from denying a resident a deduction for “interest, royalties and other disbursements” paid to a resident of the other contracting State if a deduction would be available were the amount paid to a resident of

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<sup>10</sup>Article 24 (1) of both the United Nations and OECD Model Conventions.

<sup>11</sup>Article 24 (5) of both the United Nations and OECD Model Conventions.

the residence country. This rule is not targeted at the calculation of foreign source income, but can have application in that context. It has no application except with respect to deductibility of amounts and so does not apply to tax rates or tax reliefs such as tax credits.

While these provisions prevent discrimination in the taxation of foreign source income based on nationality, ownership, control or recipient of payment, they do not prevent discrimination in the taxation of foreign source income as such. So, for example, provided those rules are not engaged, a residence country is at liberty to impose more tax on foreign source income than on equivalent domestic source income, whether that be by reason of tax rates or the availability of deductions or reliefs. Tax treaties simply do not engage with this sort of discrimination. Similarly, tax treaties do not expressly prevent more or less taxation by a residence country of income derived by its residents from some foreign countries (including tax treaty partners) when compared to income derived from other foreign countries (no most-favoured-nation requirement).<sup>12</sup>

### 1.3.2 Corresponding adjustments

Residence country taxation may also be affected by the obligation to make corresponding adjustments under tax treaties. This occurs where the other contracting State makes a transfer pricing adjustment (primary adjustment) in accordance with Article 9 (1) (Associated enterprises) or a specific allocation of profits to a permanent establishment (PE) under Article 7 (2). Article 7 (3) (OECD Model Convention only) and Article 9 (2) may require the residence country to adjust the taxation of the associated enterprise or holder of the PE resident in that country in order to avoid double taxation.<sup>13</sup> Conceptually, the

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<sup>12</sup>In this context, most-favoured-nation treatment would require the residence country to tax income derived from a particular foreign country no less favourably than income derived from any other foreign country. Alternately, national treatment in this context would require that income derived from a particular foreign country be taxed no less favourably than income derived from the residence country itself.

<sup>13</sup>Some countries take the view that the mutual agreement procedure (discussed below in section 4.3) can produce a similar result; for example, see paragraph 2 of the Commentary on Article 25 of the United Nations Model Convention.

corresponding adjustment rules are primarily targeted at the allocation of source of income between countries. However, they are not limited in that regard and in an appropriate case can be applied to residence country taxation of foreign source income.

### 1.3.3 Elimination of double taxation

The primary manner in which residence country taxation of foreign source income is affected by tax treaties is the obligation to eliminate double taxation of income that has already been taxed in the source country (Article 23). There are two alternative versions of Article 23 — the exemption method (Article 23 A) and the credit method (Article 23 B). Details of the manner in which these provisions are to be administered in the residence country are discussed below. It is first important to identify some limitations as to the scope of the obligation in Article 23 and then to consider how countries respond to those limitations.

Article 23 (whether Article 23 A or 23 B) obliges the residence country to eliminate double taxation of income of a resident that “in accordance with” the tax treaty “may be taxed” in the other contracting State. In this context, it is irrelevant whether the income can be correctly described as sourced in the other contracting State. The issue is simply whether according to the distributive rules of the tax treaty the other contracting State has a right to tax or not. The OECD (though not the United Nations) confirms that whether the other contracting State has a right to tax or not is to be determined by that other contracting State applying the tax treaty to its own law.<sup>14</sup> The right to tax (and so the residence country’s obligation to provide relief) is not tested by asking whether the other contracting State would have a right to tax if residence country law were applied. Thus, if the residence country tax administration wishes to question the source country’s right to tax (and so the residence country’s obligation to provide relief), it must engage in the difficult task of applying the tax treaty to the law of a foreign country, that is to say, the law of the source country. This does

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<sup>14</sup>Paragraphs 32.1-32.4 of the Commentary on Article 23 of the OECD Model Convention. See also the discussion in Peter A. Harris and David Oliver, *International Commercial Tax* (Cambridge: Cambridge University Press, 2010), pp. 277-8.

not mean that a residence country must agree with the source country as to the facts of a particular case or the proper application of a treaty.<sup>15</sup>

This approach in Article 23 means that elimination of double taxation by a residence country under a tax treaty is often narrower, and can be substantially narrower, than under unilateral relief rules.<sup>16</sup> First, where the source country has no right to tax under a tax treaty, the residence country has a full right to tax (in which case relief from double taxation is effectively provided by the source country). Second, the obligation to provide relief only extends to source country taxes covered by the treaty. These are outlined in Article 2 and under the Model Conventions extend to “substantially similar taxes” to those mentioned therein. Any taxes that are not so similar and, where that extension is not present in a treaty, taxes not mentioned in the treaty do not fall within the residence country’s obligation to eliminate double taxation. Third, it is usual for tax treaties to only cover taxes imposed by the contracting States and sometimes this does not extend to income taxes imposed by lower tiers of government, especially where the source country is a federal country.<sup>17</sup>

Finally, Article 23 only covers juridical double taxation (taxation of the same person with respect to the same income) and not economic double taxation (taxation of different persons with respect to the same income).<sup>18</sup> The major example of economic double taxation is the taxation of a corporation with respect to its profits when derived and the taxation of distributions of those profits in the hands of the corporation’s shareholders without relief for one tax against the

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<sup>15</sup>See paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>16</sup>Most major capital exporting countries provide some form of unilateral foreign tax relief. Typically, this means that a country will provide a foreign tax credit or exemption with respect to foreign source income of its residents irrespective of whether a treaty is in place and, in most cases, irrespective of whether the source country provides reciprocal relief.

<sup>17</sup>Article 2 (1) of both the United Nations and OECD Model Conventions does cover taxes imposed by “a Contracting State or its political subdivisions or local authorities”, but this prescription is not always followed in practice.

<sup>18</sup>For example, see paragraphs 1 and 2 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention.

other. For example, when a foreign subsidiary distributes a dividend to a local parent corporation, tax treaties presume that the source or host country will tax the profits of the subsidiary and impose at least a limited withholding tax on distributions to the parent. In addition, tax treaties presume that the residence country of the parent will tax the distribution in full and only eliminate juridical double taxation by providing a foreign tax credit for any withholding tax imposed. If capital exporting countries adopted this approach, it would place a substantial limitation in the way of cross-border direct investment and a great incentive for any such investment to be structured in a way to erode the source/host country corporation tax base of the subsidiary, for example, by ensuring deductible payments are made to the parent rather than non-deductible dividends.<sup>19</sup>

In passing, it may be noted that model tax treaties do provide for the elimination of some forms of economic double taxation, although not in Article 23. In particular, where a contracting State (for example, the source country) makes a transfer pricing adjustment under Article 9 (1) with respect to one party to a transaction, full taxation by the other contracting State of the other party to the transaction may result in a form of economic double taxation. A similar form of double taxation can arise in the context of an adjustment to the allocation of profits to a PE under Article 7 (2). In this context, the obligation on the other contracting State to make a corresponding adjustment to the profits of the other party under Article 9 (2) (or, in the context of a PE, Article 7 (3) of the OECD Model Convention only) can be viewed as a form of relief from double taxation. Further, Article 25 (3) provides that the competent authorities of the contracting States may consult for elimination of double taxation not covered by the tax treaty. There is no obligation to reach agreement in this regard and in practice this provision is rarely used and is not used as a general mechanism to provide relief from economic double taxation of corporate income.

These limitations as to the scope of Article 23 mean that often it is not followed precisely in tax treaties. In the vast majority of tax treaties the distributive rules apply equally to both contracting States. This

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<sup>19</sup>See paragraphs 49-52 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention.

is not true of Article 23. It is standard practice for tax treaties to split Article 23 into a part providing for the elimination of double taxation by one contracting State and another part providing for the elimination of double taxation by the other contracting State.<sup>20</sup> In doing so, many countries will also make provision for relief of economic double taxation of corporate income where a subsidiary in the other contracting State distributes a dividend to a parent corporation resident in the subject country. By contrast, it is rare (and increasingly so) for tax treaties to provide for relief from economic double taxation of corporate income derived by portfolio shareholders (for example, individuals and non-substantial corporate shareholders) through a corporation. Any such relief for portfolio shareholders is usually provided unilaterally in the domestic law of the residence country.

As mentioned, the obligation to provide tax treaty relief for the elimination of juridical double taxation typically depends on whether the source country has a right to tax when applying the tax treaty to that country's tax law. Most commonly, treaty provisions for relief from economic double taxation (where they exist) do not follow this approach. For example, the application of such provisions is not dependent on the distribution in question falling within the definition of "dividend" in Article 10, as applied by the source country. In providing relief from economic double taxation, often there is a separate reference to "dividend" in the Article on elimination of double taxation, which does not draw its meaning from Article 10. Rather, the meaning of any reference to "dividend" in the Article on elimination of double taxation (absent any express definition) will be determined by the residence country applying the tax treaty to its own law, and Article 3 (2) of the treaty may be relevant in this regard.

Another general limitation on the application of Article 23 as found in model tax treaties is that it is relatively brief and so does not elaborate on many of the details that are often necessary in applying the provision in practice. Other provisions in tax treaties that suffer from brevity are often supplemented with extensive commentary or guidelines, but that is not the case with Article 23. As a result, residence

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<sup>20</sup>See paragraph 30 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention.

countries often need to create domestic rules (statutory or otherwise) detailing the manner in which double taxation is to be eliminated under its tax treaties.<sup>21</sup> For this reason, it is common for the part of the Article on the elimination of double taxation that applies to a particular contracting State to refer to the provisions of that State's domestic law that eliminate double taxation. These domestic law rules may apply only to tax treaties, but more often they form the basis of unilateral foreign tax relief granted by that country, a matter considered below.

#### **1.4 Unilateral foreign tax relief**

The vast majority of developed countries and many developing countries unilaterally in their domestic law provide relief from double taxation of foreign source income of residents. Unilateral relief often (though not always) reduces the impact and significance of the obligation to provide elimination of double taxation under tax treaties. This may happen for a number of reasons. First, as mentioned, the elimination of double taxation Article in many tax treaties refers to and is limited by the scope of the domestic law rules. Second, there are instances where the method of foreign tax relief offered unilaterally is more generous than that offered under a tax treaty, in which case the taxpayer is typically entitled to insist on the unilateral relief. This particularly happens where a country's tax treaties incorporate the foreign tax credit method and the country later unilaterally implements the exemption method. Third, the scope of the unilateral relief may be broader than that available under tax treaties, such as where unilateral relief incorporates relief from economic double taxation of corporate income but tax treaties do not or where unilateral relief extends to taxes not covered by tax treaty relief (for example, excess profits taxes or State or local government income taxes, if these are not covered by a treaty).

Unilateral foreign tax relief rules are substantially different as to their structural features when compared with tax treaty rules. In particular, they are not confined by reference to a treaty; rather domestic

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<sup>21</sup>See paragraphs 38 and 60 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention.

law of the residence country will rule all aspects of scope of the relief. So, in applying unilateral rules a residence country must identify what is foreign source income for which relief is available and how that income is to be calculated (including the allocation of expenses). Contrast tax treaties, where (as mentioned above) it is the right of the source country to tax that determines the residence country's obligation to provide relief. Unilateral rules must identify when foreign taxes are sufficiently similar to domestic taxes to qualify for relief. This can be a difficult matter. Contrast tax treaties, which often clearly identify taxes to be credited (although that clarity can be blurred if the "substantially similar tax" requirement is engaged). Unilateral rules also usually provide for a nexus between the foreign tax and the foreign income in order to qualify for relief, for example, the foreign income must (according to the rules of the residence country) be seen to have a source in the foreign jurisdiction that imposes the foreign tax.

## **2. Administering the mechanics of elimination of double taxation**

Effective administration of the mechanics of elimination of double taxation requires an understanding of the accepted rationale for such relief. It is widely accepted that the obligation on the residence country to eliminate double taxation of foreign source income is consistent with the principle that the source country has the first right to tax (source country entitlement principle). This principle suggests that where a source country exercises a legitimate right to tax the residence country should not tax in such a manner as would result in double taxation. Relief from double taxation of cross-border income is consistent with a global view of allocating resources efficiently. As Article 23 illustrates, the main methods for elimination of double taxation are the exemption and foreign tax credit methods.<sup>22</sup>

The following analysis considers the main features in administering, first, the exemption method for elimination of double taxation and, then, the credit method. Each of these methods raises issues as to how expenses should be allocated between the foreign source income in

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<sup>22</sup>It is conceptually possible for a residence country to reduce the rate of tax on foreign source income, but this is rare.

question and other income of the person deriving the income (whether domestic source income or other foreign source income). The allocation of expenses can have a dramatic effect on the quantum of relief available and yet is subject to few, if any, rules in tax treaties. This is the third matter considered below. Finally, the focus turns to the mechanics of the elimination of economic double taxation of corporate income on distribution, that is to say, the taxation of foreign source dividends, whether that relief is provided unilaterally or by tax treaty.

## 2.1 Exemption method

The exemption method is conceptually simple. It suggests that if income has been appropriately taxed in the source country then the residence country should eliminate the potential for double taxation by exempting the foreign source income. The mechanics of administering an exemption system are not so simple, particularly if the residence country wants to ensure that the system is not open to abuse. If there is a lack of taxation in the source country, then the residence country providing an exemption for foreign source income means the income is not taxed at all. This can distort an efficient allocation of resources and defeat the rationale for the residence country providing relief.

For this reason, tax treaties typically limit the exemption method to income that may be fully taxed in the source country, such as income from land, business (PE), professional services and employment. However, Article 23 A (1) does not require that the source country actually tax. The fact that the source country “may” tax is sufficient to oblige the residence country to exempt the foreign source income. This can be particularly problematic where the residence country has assessed (sometimes incorrectly, because it references its own tax law) that the source country may tax, but the source country does not agree or intentionally does not tax. A good example of this is where the source and residence countries do not agree as to the scope of what is and what is not a PE (giving rise to a full source country taxing right under Article 7).<sup>23</sup> The situation can also be complicated if the residence country unilaterally offers an exemption and the scope of that

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<sup>23</sup>For a response to this type of issue, see paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

exemption is broader than the source country's right to tax under a tax treaty with the residence country.

As a result, some countries in their tax treaties, and unilaterally, require that the source country actually subject the income to tax before the residence country exemption is available.<sup>24</sup> While a potentially important limitation on the provision of an exemption, subject to tax clauses raise difficult administrative issues as to precisely what constitutes the source country subjecting foreign source income to tax. There may be issues as to the type of foreign tax that qualifies, whether the quantum of foreign tax is relevant and whether the taxpayer can elect to pay the tax in an effort to qualify for the exemption in the residence country.

Consistent with ensuring that income is fully taxed, the exemption method under tax treaties usually does not apply to income that may be taxed only partly by the source country. This is particularly the case where payments such as dividends, interest, royalties and even service fees may be subjected to a limited withholding tax in the source country. In these types of cases, tax treaties usually switch to the foreign tax credit method, a switch that is recognised in Article 23 A (2).

Even where an exemption is available, there are numerous reasons why the residence country is likely to require the taxpayer to declare the exempt foreign income in their annual tax return. One reason is simply to check that the foreign income has been properly calculated (including the appropriate allocation of expenses) and the exemption properly claimed. If a subject to tax clause applies, the taxpayer may be required to provide proof of the payment of the foreign tax. Declaration of foreign source income may be necessary for other reasons, especially where deriving exempt foreign source income has an impact on the taxation of other income or the availability of certain government benefits such as social security payments.

A number of countries adopt exemption with progression and application of this variation of the exemption method is recognized by

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<sup>24</sup>See paragraph 35 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention.

Article 23 A (3). Exemption with progression is only relevant where the taxpayer is subject to progressive tax rates. It means that exempt foreign source income may occupy lower tax brackets and push other income (domestic or foreign source) into higher tax brackets. There are different ways of applying exemption with progression and the details are usually provided by the domestic law of the residence country. The whole of the exempt foreign source income may take up the lower tax brackets or perhaps only the proportion that the exempt foreign source income is of the taxpayer's total income.

**Box 1**

**Exemption with progression for foreign income**

A resident derives 100 foreign source income and 100 domestic source income. The foreign income is taxed in the source country at the rate of 30 per cent. The residence country eliminates double taxation in the form of exemption with progression where foreign source income forms the lowest taxed slice of income. The residence country taxes at progressive rates of 20 per cent on the first 100 of income and 40 per cent on the rest.

Foreign source income	100
Source tax at 30 per cent	30
	-----
Income net of foreign tax	70
Residence exemption	-
	-----
Net return	70
Domestic income	100
Domestic tax	
20 per cent first 100 (all foreign)	-
40 per cent rest (all domestic)	40
	-----
Net return	60

If the residence country had adopted a top slicing rule, where the foreign source income was taxed at the highest rates, then the residence country tax liability on the domestic source income would have been 20.

Exempt foreign source income may also have an impact on other residence country tax attributes of the person deriving the income. The most obvious example is the use of tax losses. Most countries allow losses, especially from business activities, to reduce income from other activities or be carried forward. Where losses are available, a question is whether those losses are to be reduced by exempt foreign source income, which would mean that the losses are not available to reduce other, taxable income. This is a matter that is not regulated by tax treaties. As such, it is a matter for domestic law. Again, there are different types of rule that may be applied in this regard, from no requirement to use the losses against exempt foreign source income, to a requirement to first fully reduce any losses by exempt foreign source income. It is also possible to use apportionment rules and have a different treatment depending on whether the loss is from a foreign or domestic source.

### Box 2

#### Exempt foreign income and domestic losses

A resident has a carried forward loss of 100 from domestic activities. In the current year the resident derives 100 foreign source income and has 100 domestic source income. The foreign income is taxed in the source country at the rate of 20 per cent. The residence country eliminates double taxation in the form of exemption of the foreign source income. Nevertheless, the domestic law requires the resident to use the carried forward loss proportionately against the foreign income (before foreign tax) and the domestic income. The residence country taxes at the rate of 30 per cent.

Foreign source income	100
Source tax at 20 per cent	20
	----
Income net of foreign tax	80
Residence exemption	-
	-----
Net return	80

Carried forward loss is set against foreign income proportionately. Foreign income reduces the loss by 50. 50 remains available to set against the domestic income.

Domestic income	100
Less remaining loss	(50)
Taxable income	50
Residence tax at 30 per cent	15
	-----
Net return	85

If the residence country required the carried forward loss to be fully set against any foreign source income, the foreign source income would have exhausted the loss. In this case, the residence country tax on the domestic income would have been 30.

## 2.2 Credit method

The foreign tax credit method is the other main method by which residence countries eliminate double taxation of foreign source income and, as mentioned regarding the exemption method, is typically at least the residual method. This method is explicitly provided for in Article 23 B of the Model Conventions, although this provision is brief and does not contain many of the details required for the operation and administration of a foreign tax credit system. As mentioned, these details are typically provided by domestic law, often in the context of unilateral relief. It is fair to suggest that, so far as the rules in Article 23 B are concerned, they facilitate rather than limit the choices available to a residence country in implementing a foreign tax credit system.

The foreign tax credit system eliminates double taxation by reducing residence country tax due with respect to foreign source income by any tax imposed on that income by the source country. All foreign tax credit systems must deal with the possibility that the source country tax exceeds the residence country tax and so may give rise to what is commonly referred to as excess foreign tax credits. Virtually all foreign tax credit systems incorporate a limitation on credit, which operates so that excess foreign tax credits are non-refundable and cannot be set against tax due with respect to domestic source income (sometimes called an ordinary credit). This limitation is expressly accepted in Article 23, although that provision does not contain details as to how the limitation on credit should be calculated.

**Box 3****Limitation on credit — Excess foreign tax credits**

A resident derives 100 foreign source income. The foreign income is taxed in the source country at the rate of 40 per cent. The residence country eliminates double taxation in the form of a foreign tax credit. The residence country taxes at the rate of 30 per cent.

Foreign income	100
Source tax at 40 per cent	40
	-----
Income net of foreign tax	60
Gross-up by residence country	40
	-----
Taxable income	100
Residence tax at 30 per cent	30
Less foreign tax credit (limited to residence tax)	30
	-----
Net residence tax	0
	-----
Net return	60

Even though the foreign tax is 40, the foreign tax credit available in the residence country is limited to the residence country tax on the foreign source income. So a credit is available only for 30. Some countries permit the excess foreign tax of 10 to be used against residence country tax on other foreign source income or to be carried forward or back for use in other tax years.

Under the domestic laws of a number of countries, the credit is simply limited to the amount of domestic tax due with respect to foreign source income. Such an approach does not permit excess relief. Other countries do take into account the amount by which foreign tax may exceed domestic tax, for example, by recognizing excess foreign tax credits and permitting these to be carried forward for use in future years.

**Box 4**

**Limitation on credit — country-by-country approach**

A resident of Country B derives 100 business profits from Country A and 100 interest from Country A. The tax rate on business profits in Country A is 30 per cent and Country A imposes a final withholding tax of 10 per cent on interest paid to non-residents. Country B taxes the resident at 20 per cent.

Country A tax

Business income	100
Source tax at 30 per cent	30
Interest income	100
Source tax at 10 per cent	10
	-----
Income net of foreign tax	160

Country B tax

Gross-up (30 + 10)	40
	-----
Taxable income	200
Residence tax at 20 per cent	40
Less foreign tax credit (limited to residence tax)	40
	-----
Net residence tax	0
	-----
Net return	160

If separate calculations were required for calculation of the foreign tax credit for the business income and the interest income (that is to say, an item-by-item approach) then the credit for source tax on the business profits would have been limited to 20, that is to say, the residence country tax on those profits. There would have been excess foreign tax of 10 (30 - 20) for which no foreign tax credit would be available due to the limitation on credit. Further, there would have been 10 Country B tax payable with respect to the interest income because the Country B tax on this income exceeds the source tax by this amount. By using

the country-by-country approach to the limitation on credit, Country B permits the excess source tax on the business profits to reduce residual Country B tax on the interest income.

Irrespective of whether excess foreign tax credits may be carried forward or back, foreign tax credit systems must incorporate rules as to the scope of calculating the limitation on credit. Article 23 permits a country to calculate the limitation on credit separately for each item of income. So, for example, foreign tax paid with respect to the profits of each PE, income from each piece of immovable property, each dividend, interest or royalty, etc., would be tested against the residence country tax payable on that item of income to determine the limit of the credit available. This is often referred to as an item-by-item, source-by-source or slice-by-slice approach to calculating the limitation on credit. It can result in numerous calculations by a person deriving foreign source income from a particular treaty country. It can also mean that foreign tax that exceeds residence country tax on one item of foreign source income cannot be used to reduce residence country tax that exceeds foreign tax on another item of foreign source income, depending on how excess foreign tax credits may be used.

Some countries opt to simplify the item-by-item approach by amalgamating different items of foreign source income in some fashion for purposes of reducing the number of times the limitation on credit has to be calculated. There are a number of ways to achieve this reduction, the main difference between each type being the extent of averaging of foreign tax that is permitted. One obvious choice is to calculate the limitation by reference to foreign tax payable on all income derived by a person from a particular country, that is to say, a country-by-country limitation. This can be consistent with the bilateral nature of tax treaties, but some countries amalgamate income from numerous countries when calculating the limitation on credit. This is more likely to happen under unilateral relief.

The amalgamation may simply be all of a person's foreign source income from wherever derived. The total foreign tax paid with respect to that global amount of foreign source income is then compared to the amount of domestic tax attributable to that amount. This is referred to as a worldwide limitation on credit. Countries may also require a

separate limitation on credit calculation for particular types of foreign source income, for example, all business profits, all income from immovable property, all passive income, all capital gains, etc. This is often referred to as a type of income or basket limitation on credit, in which case the particular country from which the income is derived may be irrelevant. The worldwide and type of income approaches to the limitation on credit may be designed in such a way as to be consistent with the manner in which income is required to be calculated under domestic law, for example, according to a global or schedular approach (examined below).

Foreign tax credit systems also give rise to issues as to the manner in which a residence country taxes foreign source income. This was touched on in section 1.3.1 above, in the context of non-discrimination. Questions arise as to what expenses are deductible, if any, in calculating foreign source income and this can have a dramatic effect on calculating the limitation on credit. Deductions are dealt with in section 2.3 below. Further issues arise as to the rate at which a residence country taxes foreign source income. Some countries apply special tax rates to particular types of income, for example, dividends and capital gains are often subject to lower tax rates than other types of income. One question is whether these lower rates apply to foreign source income of the relevant type. While tax treaties do not typically deal with such issues, Article 23 requires a foreign tax credit to be granted irrespective of the domestic tax rate on the foreign source income (see the example in Box 6). Similar issues arise as to whether and in which manner particular reliefs (such as foreign source losses and allowances and tax credits available for things like research and development) are available with respect to foreign source income.

The taxation of foreign source income by a residence country at non-uniform rates can also have an impact on the manner in which the limitation on credit is calculated. This is also the case where an exemption is available with respect to some types of foreign source income, but a foreign tax credit is available with respect to other types. The issues are similar to those mentioned in section 2.1 in the context of exemption with progression. In the context of progressive rates, the issue is whether foreign source income, for which foreign tax credits are available occupy lower tax brackets (bottom slicing), are treated as occupying proportionately all tax brackets or are treated as income

subject to highest tax rates (top-slicing). Bottom slicing increases the likelihood that the limitation on credit will be engaged.

With the exemption method, only one slicing rule is required in applying exemption with progression (see Box 1). If the limitation on credit under a foreign tax credit system is calculated in any manner other than a worldwide limit, then the system will require multiple slicing rules to match the number of times the limitation on credit may be calculated. For example, if a country-by-country limitation is adopted (see Box 4), the tax law must specify whether income derived from one country is the bottom slice or whether the income derived from another country is the bottom slice. This is important because the levels of foreign tax will vary for each calculation and the order in which the country taxes foreign source income really matters to the total residence country tax liability. If a residence country exempts some types of foreign source income, for example, by adopting Article 23 A, then again the residence country must specify whether the exempt foreign income occupies lower tax brackets when compared with foreign income for which a foreign tax credit is available.

The slicing rule for ordering limitation on credit calculations may be structured in a number of ways. Foreign income subject to the lowest foreign tax may be treated as occupying lower tax brackets, or perhaps foreign income subject to the highest foreign tax. A proportionate rule may also be used. A common approach is to permit taxpayers to order their limitation on credit calculations in such a way as will produce the least amount of residence country tax, that is to say, which maximizes the availability and use of foreign tax credits.

### **Box 5**

#### **Slicing rule with taxpayer choice**

A resident of Country C derives 100 wages income from Country C, 100 business profits from Country A and 60 income from immovable property and 40 interest from Country B. Country A taxes the business profits at the rate of 30 per cent. Country B taxes the income from immovable property at the rate of 25 per cent and the interest at 10 per cent. Country C taxes the resident at progressive rates of 20 per cent on the first 150 of income and 40 per cent on the rest. There is a tax treaty

between Country A and Country C under which Country C applies the exemption method to the Country A business income. There is no tax treaty between Country B and Country C, but Country C unilaterally offers a foreign tax credit where the limitation on credit is calculated on a slice-by-slice basis. Country C permits the resident to choose which slice of income is taxed at which rate (discretionary slicing rule).

Country A tax

Business income	100
Source tax at 30 per cent	30
	-----
Income net of foreign tax	70

Country B Tax

Immovable property income	60
Source tax at 25 per cent	15
Interest income	40
Source tax at 10 per cent	4
	-----
Income net of foreign tax	81

Country C tax

Wage income	100
20 per cent on first 150	20
Country B interest income (grossed up)	40
20 per cent on first 150	8
Less foreign tax credit	4
	-----
Net residence tax	4
Country B immovable property income (grossed up)	60
20 per cent on first 150 (that is to say, 10 after wages and interest)	2
40 per cent rest (60 less 10 is 50)	20
Less foreign tax credit	15
	-----

Net residence tax	7
Country A business income (grossed up)	100
Exemption	-
	-----
Net return $(70 + 81 + 100 - 20 - 4 - 7)$	220

The resident has saved 10 Country C tax by ordering the slicing to ensure full creditability of Country B tax under the foreign tax credit system and that the exempt Country A income is subject to the highest tax rate in Country C. The total tax paid (80 from all countries) is less than if all the income were derived from Country A (90 being 20 per cent of 150 plus 40 per cent of 150).

Further complications may be caused by the interaction of the schedular nature of tax treaties with the domestic tax base of the residence country. Tax treaties adopt a schedular approach in granting source country taxing rights (that is to say, under Articles 6 to 21). Often domestic tax laws also adopt a schedular approach, calculating and taxing different types of income differently. Two schedular systems (treaty and domestic), applying to the same income, are unlikely to be the same and this can have consequences especially in calculating the limitation on credit, especially where a type of income limitation is adopted. This can result in the need for apportionment rules in allocating foreign tax to particular types of income as determined for domestic law schedular purposes.

### Box 6

#### Foreign tax credit — Schedular apportionment of foreign tax

A resident of Country B derives 100 business profits from Country A. Country A is a civil law jurisdiction that adopts a balance sheet approach to the calculation of income. Country A taxes the profits at the rate of 25 per cent. Country B is common law jurisdiction that taxes capital gains separately from income (revenue gains). It taxes the business income at the rate of 30 per cent and capital gains at the rate of 20 per cent. Country B determines that 40 of the business profits is a capital gain. Country B eliminates double taxation in the form of a foreign tax credit with a separate limitation on credit for income and capital gains.

Country A tax	
Business income	100
Source tax at 25 per cent	25
	-----
Income net of foreign tax	75
Country B tax	
Business income (100 less 40 capital gain)	60
Residence tax at 30 per cent	18
Less foreign tax credit (apportioned as 60 per cent of 25)	15
	-----
Net residence tax	3
Capital gain	40
Residence tax at 20 per cent	8
Less foreign tax credit (apportioned as 40 per cent of 25, but limited to residence country tax)	8
	-----
Net residence tax	-
	-----
Net return	72
The Country A tax on the unified business profits has been apportioned proportionately between the income and capital gain for Country B tax purposes. This causes the limitation on credit on the capital gain to be engaged in Country B and the resident pays more tax in total (28) than they would if the income were derived only from Country A (25) or only from Country B (26).	

Some countries apply special mechanisms to the collection of domestic tax with respect to foreign source income. For example, a domestic agent (such as a local bank or bank branch), acting on behalf of a non-resident, paying say dividends, may be required to withhold tax from the payment of the (foreign source) dividends. Such matters are not covered by tax treaties, but can have an impact on the

application of the foreign tax credit method. If the withholding tax is a final tax, then it may be possible for the withholder (agent) to reduce the amount of domestic tax withheld by the amount of any foreign tax credit available to the recipient (because the agent may know how much foreign tax was imposed on the dividends). However, if the domestic withholding tax is not final, then it is likely that the limitation on credit will be calculated in such a way that it is not possible for the withholder to calculate the foreign tax credit. In such a case, the taxpayer will have to declare the foreign source income and claim a credit for both the domestic withholding tax and the foreign tax. In such a case, countries invariably allow the taxpayer to apply the foreign tax credit first and maximize a claim for refund of domestic withholding tax credits.

### Box 7

#### Foreign tax credit — Schedular with non-final residence withholding tax

A resident of Country B derives a dividend of 100 from Country A through a representative bank branch in Country B. Country A taxes the dividend at the rate of 10 per cent. Country B requires the bank to withhold tax at the rate of 25 per cent, but this can be reduced by the Country A tax. Country B taxes residents at progressive rates of 20 per cent on the first 80 of income and 40 per cent on the rest. A resident may elect to not declare dividends in their tax return and treat the withholding tax of 25 per cent as final.

##### Country A tax

Dividend	100
Source tax at 10 per cent	10
	-----
Income net of foreign tax	90

##### Country B tax

Dividend (grossed up)	100
Bank withholding tax at 25 per cent	25
Less foreign tax credit	10
	-----

Net residence withholding tax	15
Shareholder income (grossed up)	100
20 per cent on first 80	16
40 per cent rest (100 less 80 is 20)	8
Less foreign tax credit	10
Less withholding tax credit	15
	-----
Net residence tax	(1)

As the foreign tax credit will typically be applied against the shareholder tax before the withholding tax credit, the excess credit of 1 is attributable to the withholding tax and so will usually be refunded to the shareholder, making a net return of 76. If the resident's Country B tax liability on the dividends were any higher (for example, the resident had other income) then the taxpayer is likely to have elected not to declare the dividends, in which case the effective tax rate on that source of income would be 25 per cent (Country A and Country B taxes).

As noted above, tax treaties often identify which foreign tax qualifies for a foreign tax credit, that is to say, taxes covered by the treaty (Article 2). By contrast, unilateral foreign tax credit systems have to identify which types of foreign taxes are sufficiently similar to the residence country income tax to qualify for a foreign tax credit. This can mean that unilateral foreign tax relief is broader than tax treaty relief and raises issues as to which relief applies. As a general rule, domestic law often permits taxpayers to choose between tax treaty and unilateral relief, especially where unilateral relief is more generous.

The tax year of the source country may be different from the tax year of the residence country and the timing of tax instalments and final tax payments can vary dramatically. A foreign tax credit system needs to relate foreign tax paid to a particular tax year. It may do this by associating the foreign tax with particular foreign source income or simply by granting a foreign tax credit for foreign tax paid within a particular year. These sorts of details are not covered by tax treaties and again are typically dealt with in domestic law.<sup>25</sup>

<sup>25</sup>For example, see paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention.

**Box 8****Use of losses — Excess foreign tax credits**

A resident derives 100 foreign source income and has 200 losses from domestic activities. The foreign income is taxed in the source country at the rate of 20 per cent. The residence country eliminates double taxation in the form of granting a foreign tax credit. It requires domestic losses to reduce foreign income. It taxes the resident at the rate of 30 per cent. It permits both losses and excess foreign tax credits to be carried forward for use in future years.

Foreign income	100
Source tax at 20 per cent	20
	-----
Income net of foreign tax	80
Gross-up by residence country	20
	-----
Taxable income	100
Domestic losses	(200)
Residence tax	-
Less foreign tax credit (limited to residence tax)	-
	-----
Carry forward loss (200 - 100 foreign income)	(100)
Carried forward excess foreign tax	20

The use of the domestic losses against the foreign source income means that no residence country tax is due with respect to that income. This engages the limitation on credit, meaning that no foreign tax credit is available. However, the residence country permits excess foreign tax to be carried forward. In effect, 100 of the domestic loss is converted into 20 carried forward excess foreign tax.

Finally, as with exempt foreign source income, there are issues as to how the foreign tax credit method interacts with the application of domestic loss relief. If losses (foreign or domestic) reduce foreign source income for which a foreign tax credit is available, then the limitation on credit will be lower, that is to say, the application of losses increases the likelihood of excess foreign tax credits. One way to look

at this is that the losses have been converted into excess foreign tax and this raises the issue of the manner in which excess foreign tax can be used, if any.

Again, foreign tax credit countries have a number of options as to how to deal with the interaction between losses and the limitation on credit. They may force the losses to be used against foreign source income, accepting that excess foreign tax credits may be worthless or at least worth less than the losses that gave rise to them (for example, because domestic losses are involved and they could otherwise be set against domestic source income). Alternately, the losses may be quarantined so that they cannot be set against particular types of foreign source income for which foreign tax credits are available. Various versions of a proportionate rule may also be used. Again, a popular approach is to permit the taxpayer to choose whether the loss is used to offset foreign source income or not.

Finally, tax sparing is of particular importance for developing countries in concluding treaties with countries that adopt the foreign tax credit system. Tax sparing involves the residence country granting foreign tax credits for tax that the source country has intentionally forgone in order to attract investment. The appropriateness of tax sparing has been intensely discussed for many years and is noted in the Commentaries of the United Nations and OECD Model Conventions.<sup>26</sup> The form of tax sparing is typically unique and varies substantially from treaty to treaty (if it is available). However, a few general observations may be made.

The main difficulty for a residence country in administering tax sparing is identifying the tax forgone for which a foreign tax credit is to be granted. Almost inevitably, the tax forgone will be identified with respect to a particular type of income, for example, income from manufacturing, agriculture, construction or even passive income, such as dividends, interest and royalties. If the income identified is too general,

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<sup>26</sup>See paragraphs 1-11 of the Commentary on Article 23 of the United Nations Model Convention. See also paragraphs 72-78.1 of the Commentary on Article 23 of the OECD Model Convention, reproduced and elaborated on in paragraphs 16-18 of the Commentary on Article 23 of the United Nations Model Convention.

the country granting tax sparing may have concerns if circumstances change, for example, the economic environment changes such that the residence country's reason for granting tax sparing relief no longer exists. This has led to a practice where more recent tax sparing provisions are often more targeted. In particular, a tax sparing provision may have a sunset clause, that is to say, an agreed time at which it will cease to apply unless extended. Tax sparing may be limited to activity within a specific geographical area. Tax sparing is also commonly limited by reference to specific provisions in the source country's tax law and requires renegotiation if these provisions are altered in a material respect.<sup>27</sup>

In all of these matters, the tax administration of the residence country has an interest in checking that tax sparing is appropriately claimed. It may require certain proof before accepting a claim for tax sparing. This may take the form of evidence that the income in question was declared in a tax return to the source country and specifically granted relief by that country. It will also be necessary to quantify specifically the amount of tax forgone and the residence country tax administration is likely to require evidence as to the manner in which the tax forgone is calculated. Some residence countries may require a certificate from the source country tax administration to support these matters. Nevertheless, a residence country may remain concerned at the possibility of relief in the source country (which is eligible for tax sparing) being manipulated and artificially claimed in circumstances where the relief is not intended to apply. In this context, a residence country may incorporate anti-abuse rules into the tax sparing provision or reserve the right to apply domestic anti-abuse rules.

Once the application of tax sparing is determined and the amount of source country tax forgone is quantified, tax sparing raises few issues in addition to those generally raised by a foreign tax credit system.

A "matching credit" is similar to a tax sparing credit in that the residence country grants a foreign tax credit for tax which the source country didn't levy. However, in this case, it is not tax forgone that is

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<sup>27</sup>See paragraph 12 of the Commentary on Article 23 of the United Nations Model Convention.

credited by the residence country. The residence country simply credits more tax than would normally be imposed under the source country tax law. A common example is where the source country imposes a dividend withholding tax of, for example, 15 per cent, but the residence country grants a credit for 25 per cent, for example.

**Box 9**

**Foreign tax credit — Tax sparing**

A resident of Country B derives 100 profits from operation of a water treatment plant in Country A. Country A taxes business profits at the rate of 25 per cent, but grants a tax holiday of five years for start up infrastructure projects and so does not tax the resident of Country B. Country B taxes business income at the rate of 30 per cent. Country B eliminates double taxation in the form of a foreign tax credit, but grants tax sparing under its tax treaty with Country A for start up infrastructure projects.

**Country A tax**

Business income	100
Source tax at 25 per cent	25
Less benefit of tax holiday	25
	-----
Income net of foreign tax	100

**Country B tax**

Business income	100
Residence tax at 30 per cent	30
Less foreign tax credit (includes Country A tax forgone under the tax holiday)	25
	-----
Net residence tax	5
	-----
Net return (100 – 5)	95

Tax sparing does not produce the same result as exemption, because residual Country B tax is payable. In order to grant the tax sparing credit, Country B may require evidence that the water treatment plant

is a start-up infrastructure project that properly qualifies for the tax holiday in Country A. Further, Country B may require evidence of the calculation of the income for Country A tax purposes so as to accurately quantify the amount of tax forgone that qualifies for tax sparing.

### 2.3 Deduction of expenses

Whether a residence country adopts the exemption method or the credit method and whether it does it by tax treaty or unilaterally, it will need rules for allocating expenses between foreign and domestic source income. In the case of the exemption method, this is needed to ensure that expenses incurred with respect to exempt income do not reduce taxable income. In a foreign tax credit system, this apportionment is needed in order to appropriately apply the limitation on credit. This is particularly important where the foreign tax would otherwise exceed the domestic tax liability on the relevant foreign source income. It is common for an amount of cross-border income to be calculated differently by source and residence countries and questions about the deductibility of expenses are often the cause of this.<sup>28</sup>

Again, the allocation of expenses by a residence country between domestic source income and foreign source income, or between foreign source income and other foreign source income, is the sort of detail that tax treaties do not generally deal with. While tax treaties regulate to some extent deductions claimed in the source country (for example, under Article 7 and its Commentary)<sup>29</sup> they have virtually no impact

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<sup>28</sup>Generally, regarding residence country allocation of expenses between foreign source income and domestic source income, see Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2010), pp. 458-60 and 471-3, and Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 313-8.

<sup>29</sup>There are substantial differences of opinion even here, as evident in the differences between Article 7 of the United Nations Model Convention and the post-2010 version of Article 7 of the OECD Model Convention. In particular, Article 7 (3) of the United Nations Model Convention provides some prescriptive rules as to the deduction of expenses in the country in which a PE is situated. Generally, regarding this provision, see Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 159-62.

on the deductibility of expenses in the residence country. In principle, it is not contrary to a tax treaty for a residence country to discriminate against residents deriving foreign source income, whether by reason of application of tax rates, denial of concessions available with respect to domestic source income or the non-deductibility of expenses.<sup>30</sup>

As a matter of domestic tax law, the allocation of expenses by residence countries to foreign source income is often not very detailed. In general, there are two extreme approaches that a residence country may adopt and these reflect approaches to allocation of income between countries.<sup>31</sup> At one extreme, a country may adopt a transactional approach and seek to determine the extent to which a particular expense is incurred in deriving the foreign source income in question. Some expenses will be difficult to attribute, such as interest on a loan where there will be a need to trace the use of the funds borrowed in order to determine an appropriate allocation of the interest expense, in some cases a near impossible task.

At the other extreme, a residence country may adopt some form of overall apportionment approach for allocating expenses to foreign source income. For example, expenses may be allocated to particular income-earning activities based on turnover or a mixture of factors such as assets, payroll and sales.<sup>32</sup> As with a formulary apportionment process to income allocation, the apportionment formula may be very general (for example, one factor) or may become increasingly

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<sup>30</sup>As discussed in section 1.3.1, the non-discrimination rules in Article 24 may provide limited exceptions but the rules in Article 24 do not prevent discrimination against deriving foreign source income as such. In particular, Article 24 (4) only requires that a deduction be granted for a payment to a treaty partner resident if it would be available for a payment to a resident. It is permissible for a residence country to permit a deduction for an expense in deriving domestic source income, but deny such a deduction in deriving foreign source income, provided that deduction is denied irrespective of whether the expense is paid to a resident or a non-resident person.

<sup>31</sup>It is also possible to permit the taxpayer some discretion in the allocation of expenses, but this possibility is discounted in the present review.

<sup>32</sup>Corporate groups raise particular issues in this regard as they may be used in such a way as to itemize the allocation of expenses. Therefore, it may be that the apportionment occurs at the group level rather than at the level of individual corporations.

itemized until eventually the transactional approach is approximated. Often countries adopt a mixed approach. For example, it is common for expenses that are easily identified as directly related to particular income to be allocated to that income (for example, cost of assets), whereas more general expenses are allocated on an apportionment basis (for example, overheads). Generally accepted accounting practice can be particularly important in the allocation of expenses for tax law purposes, but is not always determinative.

### Box 10

#### Allocation of expenses

A resident of Country B derives 200 gross business income (for example, sale proceeds); 100 from a PE in Country A and 100 from Country B. The resident incurs expense of 20 in renting business premises in Country A and 40 in renting business premises in Country B. The resident also incurs 80 interest expense on funds borrowed to finance the business (in both countries). Country A uses a tracing approach to allocate expenses and so allocates 20 rent and 30 interest to the PE situated there. Country A taxes business profits at the rate of 20 per cent. Country B allocates expenses based on gross business income and so allocates 30 rent and 40 interest to the Country A PE. Country B taxes business profits at the rate of 30 per cent.

#### Country A tax

Business income (100 less 20 rent and 30 interest)	50
Source tax at 20 per cent	10
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Income net of foreign tax	40

#### Country B tax

Business income (200 less 60 rent and 80 interest)	60
Residence tax at 30 per cent	18
Less foreign tax credit (limited to residence tax of 9; being 30 per cent of 30 (100 less 30 rent and 40 interest))	9
	-----
Net residence tax	9
	-----

Net return (60 - 10 - 9)

41

Country A and Country B adopt different approaches to the allocation of expenses. This causes Country B to view the amount of income derived from Country A (30) as less than Country A does (50). The consequence is that Country B's limitation on credit is engaged despite Country B's tax rate (30 per cent) being substantially higher than Country A's (20 per cent). The situation would have been the same if Country B had applied the exemption method. In this case Country B would exempt only 30 income and impose tax of 9 on the other (domestic) income of 30.

Where expenses related to foreign source income exceed that income, the result is a foreign loss. Foreign losses have an intricate interplay with systems for the elimination of double taxation.<sup>33</sup> Many countries feel a need to quarantine foreign losses so that they cannot offset domestic source profits. Just as tax treaties do not extend to the allocation of expenses in the residence country, they do not extend to the treatment of losses from foreign activities. Domestic law of the residence country will determine the extent to which such a loss may be set against domestic source income or against foreign source income from other foreign activities.<sup>34</sup>

Countries that adopt the exemption method with respect to particular foreign activities (for example, a foreign PE) often refuse to recognise losses from such activities. However, a few countries do allow such losses to reduce domestic source income, but on the condition that when the activities turn profitable those profits are not exempt to the extent that foreign losses were previously taken into account. This is commonly referred to as clawing back the benefit of the earlier use of the losses or reintegration of the loss.<sup>35</sup>

<sup>33</sup>Generally regarding foreign losses, see Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: Structural Analysis*, supra footnote 28, pp. 460-2 and 473-4, and Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 322-4

<sup>34</sup>For example, see paragraphs 44 and 65 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>35</sup>In particular, the latter term is often used in Europe, as in Case C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenhaus Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-8061 (ECJ).

**Box 11****Exemption — Claw back of foreign losses**

In year 1, a resident of Country B incurs a loss of 100 in business activities conducted through a PE in Country A. During that year, the resident also derives 100 business income from Country B. Country B taxes the resident at the rate of 25 per cent, but permits the use of foreign business losses against domestic business income. In year 2, the resident derives 100 business income through the Country A PE. The resident also derives 100 business income from Country B. Country A taxes business income at the rate of 20 per cent. Country B exempts the profits of a foreign PE, but reduces the exemption by any losses of the PE claimed in previous years.

**Year 1 – Country A tax**

Country A business loss (available for carry forward)	(100)
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**Year 1 – Country B tax**

Country B business income	100
Less country A loss	(100)
	-----
Net country B tax	-

**Year 2 – Country A tax**

Country A business income	100
Less Country A loss carried forward	(100)
	-----
Net Country A tax	-

**Year 2 – Country B tax**

Country B business income	100
Country A business income (loss claw back)	100
Residence tax at 25 per cent	50
	-----
Net return	150

In year 1, Country B permits the Country A loss to reduce Country B source income even though Country B would exempt any profits if the

foreign activities were profitable. In this way, the foreign loss reduces Country B tax on Country B source income. However, when the foreign activities turn profitable, Country B denies an exemption for the foreign profits to the extent foreign loss relief was granted in previous years. In effect, the year 1 Country B tax on Country B source income is deferred to year 2. The foreign loss causes only a temporary erosion of the Country B tax base.

For a foreign tax credit country, it is natural that foreign losses are recognized. The question for such a residence country is whether those losses can only be carried forward for use against profits from the same foreign activity (quarantined), or whether they may be used against income from other sources, whether domestic source income or foreign source income. At some level, it might be suggested that the same approach should be followed as used in the foreign tax credit system, for example, type of income, country-by-country or world-wide approach. This would suggest, presuming an ordinary foreign tax credit is adopted, that foreign losses should not be available to reduce domestic source income. However, in practice, many countries do allow that to happen. One reason is that the relief provided is often clawed back automatically under the foreign tax credit method in the future if the foreign activities turn profitable.<sup>36</sup>

### **Box 12**

#### **Foreign tax credit — Quarantine of foreign losses**

In year 1, a resident of Country C incurs a loss of 100 in business activities conducted through a PE in Country A. The resident also derives 50 business income from Country B and 100 business income from Country C. Country B taxes the business income at the rate of 30 per cent and Country C taxes at the rate of 25 per cent. In year 2, the resident derives 100 business income through the Country A PE. The resident also derives 50 business income from Country B and 100 business income from Country C. Country A taxes the business income at the

<sup>36</sup>This happens if the losses are carried forward in the source country. Future source country income is exposed to full residence country taxation without a foreign tax credit when that income is sheltered from source country taxation by the losses.

rate of 20 per cent. Country C grants a foreign tax credit with a world-wide limitation on credit. It quarantines foreign losses on a similar basis, but does not permit the carry forward of excess foreign tax credits.

Year 1 – Country A tax

Country A business loss (available for carry forward)	(100)
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Year 1 – Country B tax

Country B business income	50
Country B tax at 30 per cent	15

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Income net of Country B tax	35
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Year 1 – Country C tax

Country C business income	100
Country C tax at 25 per cent	25

Foreign business loss (100 Country A loss less 50 Country B income) (available for carry forward)	(50)
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Less foreign tax credit (limited to residence tax of nil)	-
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Net return (150 – 100 – 15 – 25)	10
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Year 2 – Country A tax

Country A business income	100
Less Country A loss carried forward	(100)

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Net Country A tax	-
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Year 2 – Country B tax

Country B business income	50
Country B tax at 30 per cent	15

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Income net of Country B tax	35
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Year 2 – Country C tax

Country C business income	100
---------------------------	-----

Country C tax at 25 per cent	25
Foreign business income (150 less carried forward loss of 50)	100
Country C tax at 25 per cent	25
Less foreign tax credit (Country B tax)	15
Net return (250 - 15 - 25 - 10)	200

The resident has derived 300 of income over two years and suffered 90 in tax (40 in year 1 and 50 in year 2), giving an effective tax rate of 30 per cent. This is 10 more than the example suggests should be levied, that is to say, 50 Country C tax (25 per cent of 200) and 30 Country B tax (30 per cent of 100). In year 1, the loss from Country A means there is no effective Country C foreign tax credit for the Country B tax of 15. That is partly remedied in year 2 due to the worldwide limitation on credit. It might be expected that 25 of the 30 Country B tax (both years) would have been credited by Country C, that is to say, excess foreign tax credits of 5. As it is, only 15 has been credited (all in year 2) and the difference of 10 is the amount of additional tax that has been collected by Country A (all in year 2) with respect to the foreign income. This is due to the interaction of the quarantining of foreign losses and the limitation on credit.

Many countries permit, through one mechanism or another, the losses of one member of a corporate group to offset the profits of another member of the group. As a general rule, countries do not permit the losses of a foreign group member to offset the profits of a resident group member.<sup>37</sup> Again, this is a matter for domestic law that is not directly affected by tax treaties.

## 2.4 Underlying relief<sup>38</sup>

The domestic tax laws of most countries provide some form of relief from the economic double taxation of corporate income (taxation of

<sup>37</sup>Generally, regarding cross-border use of group losses, see Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 333-4.

<sup>38</sup>For a general discussion of issues that arise on the taxation of foreign dividends by a residence country, see Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice* (Cambridge: Cambridge University Press, 2013), pp. 367-80.

corporate income when derived and again when distributed). As mentioned, the Model Conventions do not deal with this form of economic double taxation, especially from the residence country's perspective.<sup>39</sup> In particular, the non-discrimination rule (Article 24) does not prevent a country from applying dividend relief to domestic source dividends while applying economic double taxation (classical system) to foreign source dividends. In practice, many tax treaties do provide relief from economic double taxation of corporate distributions in the residence country.<sup>40</sup> This relief is usually limited to dividends paid with respect to direct investment, that is to say, parent corporations in receipt of dividends, and for this purpose a definition of direct investment is required, which may, but likely will not, reflect the definition for lower source country taxation of dividends in Article 10 (2). Similarly, many residence countries unilaterally provide relief from economic double taxation of foreign source dividends.

Whether the relief from economic double taxation of foreign dividends by a residence country is provided under a tax treaty or unilaterally, it usually takes the form of the exemption or credit method, in the latter case referred to as an underlying or indirect foreign tax credit. The general issues dealt with above regarding each of these methods also apply in the context of providing underlying relief, for example, allocation of expenses, forms of limitation on credit, and identification of creditable foreign tax. However, underlying relief raises additional issues.<sup>41</sup> If its availability is limited to parent corporations, then the type and level of shareholding required must be specified. Commonly, this can be as low as 10 per cent, but much higher shareholdings are also used. There are issues as to whether only direct shareholdings count, or whether shares held through other related corporations count towards determining if the threshold is met, that is to say, indirect holdings are also counted.

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<sup>39</sup>There is a limited measure for relief of economic double taxation of parent corporations in Article 10 (2) from a source country's perspective.

<sup>40</sup>For options in this regard, see paragraph 52 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>41</sup>Generally, see Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 286-91.

Whether the exemption or indirect foreign tax credit method is adopted, a system providing underlying relief must identify the type of distributions made by non-resident corporations that may qualify for the relief. Tax treaties, if they provide for underlying relief, rarely deal with this matter in any detail. Domestic tax law may be more specific as to whether only something that may be described as a “dividend” under corporate law can qualify or whether certain receipts that a domestic tax law may deem to be a dividend also qualify for underlying relief, for example, interest paid on profit-sharing debentures or convertible notes, liquidation distributions, returns of capital or the price paid on a share buy-back.

Indirect foreign tax credit systems raise additional issues. An indirect foreign tax credit system is a form of imputation system, that is to say, corporation tax paid by the distributing corporation with respect to the profits distributed is imputed to the parent corporation. In addition, it raises issues of allocating and apportioning foreign tax paid with respect to corporate income to particular distributions. In particular, the distributing corporation may have paid corporation tax at various rates with respect to its profits. When it distributes only part of those profits, an indirect foreign tax credit system must determine which profits have been distributed.<sup>42</sup>

Different countries adopt different approaches in identifying which profits have been distributed for the purposes of an indirect foreign tax credit system. There may be an ordering rule based on when the profits were derived, for example, first in first out. There may also be an ordering rule based on the amount of corporation tax paid with respect to the profits, for example, highest taxed profits distributed first. There may be an overall apportionment, for example, all retained corporate profits are distributed proportionately. It is also possible that the distributing corporation has some discretion in identifying the profits that have been distributed. Even if there is no such discretion, without complex rules for looking through and amalgamating the identity of members of a corporate group, some discretion can often

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<sup>42</sup>For a comprehensive discussion of allocation of corporate profits and corporate tax to corporate distributions and the indirect foreign tax credit system as an imputation system, see Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra footnote 38, pp. 298-326 and 378-9 and the references cited therein.

be obtained through strategic distributions within a corporate group, that is to say, through the use of mixer corporations.<sup>43</sup>

### Box 13

#### Underlying foreign tax credit, including mixer

Parent corporation resident in Country C holds all of the shares in Sub 1, a corporation resident in Country B, which holds all of the shares in Sub 2, a corporation resident in Country A. Sub 2 derives 100 investment income, which is taxed in Country A at 20 per cent. Sub 1 derives 100 business income, which is taxed in Country B at 28 per cent. It also receives a dividend from Sub 2 of 48, which is exempt in Country B (participation exemption). Parent receives a dividend of 90 from Sub 1, which is taxed in Country C at 25 per cent. Country C offers a unilateral indirect foreign tax credit calculated on a slice-by-slice basis, with credit for tax paid by lower tier subsidiaries but with no classification look-through rules, and considers subsidiary dividends as distributed first, and proportionately, from current year profits. Neither Country A nor Country B imposes dividend withholding tax.

#### Country A tax — Sub 2

Country A investment income	100
Country A tax at 20 per cent	20

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Income net of Country B tax	80
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#### Country B tax — Sub 1

Country B business income	100
Country B tax at 28 per cent	28

<sup>43</sup>A mixer corporation is a non-resident holding corporation that is used to receive income taxed at various rates from related foreign corporations in order to mix the income so that it is on average taxed at a rate approximating the corporate tax rate in the residence (parent) country. In this way, when the mixer corporation distributes to the parent corporation, the parent corporation is entitled to a foreign tax credit that exhausts any residence country tax liability. The effect is to minimize the impact of the residence country's limitation on credit. Generally, regarding mixer corporations and underlying foreign tax credits, see Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 290-1 and 407-410.

Country A dividend	48
Country B tax (participation exemption)	-
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Income net of Country B tax	120
Country C tax — Parent	
Country B dividend (3/4 of Sub 1's retained profits)	90
Gross-up (3/4 of tax on Sub 1's income, that is to say, 3/4 of 28 Country B tax on business income and 3/4 of 12 Country A tax on profits underlying the dividend of 48)	30
	-----
Taxable income	120
Country C tax at 25 per cent	30
Less foreign tax credit	30
	-----
Net Country C tax	0
	-----
Net return (32 in Sub 2 (80 - 48), 30 in Sub 1 (120 - 90) and 90 in Parent)	152
Sub 2 has distributed sufficient profits to Sub 1 so as to mix profits held by Sub 1 to an effective tax rate of 25 per cent. This ensures that when Sub 1 distributes profits to Parent the foreign tax credit is equal to the Country C tax. Because Country C has no characterization look-through rules, it only sees one slice of income, that is to say, a dividend, and not the investment income and business income that make up the profits from which the dividend is distributed. This avoids Country C's slice-by-slice limitation on credit, which would have been engaged if a dividend were distributed only from the business profits, that is to say, because Country B's tax rate is higher than in Country C. The overall effective tax rate on the 200 profits (derived by both Sub 1 and Sub 2) is 24 per cent, that is to say, lower than either Country B or Country C's tax rate. This is because lower taxed profits remain in Country A. The remaining 30 profits in Sub 1 can be repatriated to Parent without further Country C tax. If the remaining 32 profits in Sub 2 were repatriated to Parent they would be subject to further Country C tax of 2, taking the effective tax rate up to Country C's rate of 25 per cent.	

If tax treaties deal with underlying foreign tax relief for foreign source dividends, the provisions are usually limited to direct investors.<sup>44</sup> However, there is an increasing trend, particularly in European countries, to grant more arbitrary forms of dividend relief to non-corporate shareholders generally and extend this relief to foreign dividends. The relief often takes the form of a limited dividend exemption or, more commonly, a lower tax rate applied to dividends (for example, see Box 7).<sup>45</sup>

### 3. Administering anti-avoidance rules

As noted above, tax treaties have two primary purposes — elimination of double taxation (section 2) and the prevention of fiscal evasion. The latter topic is considered specifically in another chapter,<sup>46</sup> but it is useful to make a few comments at this stage in the specific context of residence country taxation of foreign source income. As mentioned, much of that taxation is not regulated by tax treaties directly. Nevertheless, residence country taxation of foreign source income is just as prone to tax planning, tax avoidance and tax evasion as the taxation of domestic source income. There are two aspects to this. The first is whether anti-abuse rules that apply generally also apply to the taxation of foreign source income. The second is whether the nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance.

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<sup>44</sup>During the 1970s to 1990s, there was a tax treaty practice by some European countries to grant dividend tax credits available to resident shareholders to treaty partner shareholders, especially portfolio shareholders. This involved relief from source country tax. Residence countries reciprocated by, in effect, granting direct foreign tax credits to the shareholder for tax that had only been paid at the corporate level in the source country. Most of these treaties have now been replaced or amended to remove this provision. See Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra footnote 38, pp. 351-4.

<sup>45</sup>See Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra footnote 38, pp. 375-8 and Peter A. Harris, Cross-border Dividend Taxation in the 21<sup>st</sup> Century: the [Ir]relevance of Tax Treaties, *British Tax Review*, 2010, No. 6, pp. 573-88.

<sup>46</sup>See chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

### 3.1 Application of domestic rules

Income tax laws commonly contain different types of anti-abuse rules. These might address specific issues, such as excessive debt financing, transfer pricing, sale of loss corporations, use of service corporations, hidden profit distributions, dividend stripping, income splitting or assignment of income, etc.<sup>47</sup> Income tax laws also commonly incorporate, or are subject to, a general approach to tax law abuse, such as a general anti-avoidance rule or substance over form doctrine. From a domestic law perspective, such anti-abuse rules typically apply to the taxation of foreign source income in the same manner as they apply to the taxation of domestic source income.<sup>48</sup> Further, as a general rule, because tax treaties do not limit the scope of a residence country's right to tax foreign source income, they do not restrict the application of domestic anti-abuse rules to foreign source income.

### 3.2 Rules targeted at foreign source income

The nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance. These are broadly of two types—those that manipulate whether the residence country is required to provide foreign tax relief, and those that manipulate the time at which foreign income is recognized by the residence country and so subject to tax. The former is often, in principle, regulated by tax treaties, whereas the latter commonly is not.

The circumstances in which the provision of relief for elimination of double taxation can be manipulated relate to the structural features of the form of relief. So, where the exemption method is available, taxpayers may seek to manipulate their circumstances so as to ensure relief in circumstances where the rationale for relief is not present. A good example of this is the one mentioned above, where the taxpayer arranges their affairs in such a way that the source country takes the

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<sup>47</sup>Many of these domestic rules are discussed in Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra footnote 38, pp. 93-103 (transfer pricing), 176-80 (service corporations and assignment of income), 198-204 (excessive debt financing), 215-29 (hidden profit distributions), 439-89 (sale of loss corporations) and 583-6 (dividend stripping).

<sup>48</sup>For example, see Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis*, supra footnote 28, pp. 527-9.

view that the taxpayer does not have a PE situated in that country but the residence country does so. This can result in no source country taxation, but the residence country nevertheless seeking to relieve the (non-existent) double taxation by exempting the profits of the taxpayer's activities in the source country (mismatch of PE characterization).<sup>49</sup> Another example is where the taxpayer may elect to be taxed in the source country (and does so) so as to meet a "subject to tax requirement" for claiming an exemption in the residence country.

The foreign tax credit method can also be abused. The use of mixer corporations to avoid limitation on credit rules was mentioned above (see Box 13). Source countries have sometimes participated in the manipulation, such as where they grant designer tax rates so as to maximize relief in the residence country. The scope of the relief may also be abused, such as where the residence country provides underlying foreign tax credits for a payment that is deductible in the source country. Here the potential for abuse may not be as great as under the exemption method, but residence country tax savings may still be pursued.<sup>50</sup>

Historically, the biggest problem for residence country taxation of foreign source income has been deferral of that taxation by retaining the income in a foreign corporate tax shelter. As corporations are separate legal entities and typically separate taxpayers, the controllers of a corporation (often high-wealth, high-tax rate individuals) can cause the corporation to retain profits in order to avoid the higher tax rates of their shareholders. This can happen in a purely domestic context if there is sufficient difference between the corporate tax rate and the highest personal marginal rate. However, when this is looked at internationally it is a particular problem because individuals have the

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<sup>49</sup>Article 23 A (4) of the OECD Model Convention is intended to deal with such a situation, at least where the exemption in the source country is by reason of the manner in which that country has applied the treaty. Also, see paragraphs 56.1-56.3 of the Commentary on Article 23 of the OECD Model Convention and paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>50</sup>Generally, regarding hybrid mismatches, see OECD (2012), *Hybrid mismatch arrangements: Tax policy and compliance issues*, and Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 345-68.

possibility of retaining the profits of their controlled corporations in tax havens where they are subject to little or no taxation.<sup>51</sup>

As a response, numerous countries have enacted controlled foreign corporation rules. These rules can be complex, but their general thrust is to tax resident shareholders on their proportionate share of profits of a non-resident corporation (whether the profits are distributed or retained) that is controlled by residents. At a conceptual level, controlled foreign corporation rules are an example of the tax law lifting the corporate veil. As usual with residence country taxation, outside of limited examples, tax treaties do not specifically regulate the application of controlled foreign corporation rules. The OECD Commentaries suggest that such rules are broadly consistent with tax treaties.<sup>52</sup>

Some countries' anti-abuse rules go further and apply to income derived through foreign corporations that are not controlled by residents. Here, the target is to prevent the benefits available through the foreign corporation deferring repatriation to the residence country and so taxation of foreign dividends. Most commonly, such rules are only targeted at the deferral of tax on foreign dividends. However, some countries have introduced a general rule deeming income from shares that applies on a non-discriminatory basis. Again, these types of details are not addressed in tax treaties.

These anti-deferral rules have historically been targeted at all resident shareholders in foreign corporations, whether corporate or non-corporate. Globalization is now a substantial challenge to the application of anti-deferral rules as taxpayers are increasingly willing to move their country of residence in order to avoid them. This challenge is particularly dramatic in the case of corporate shareholders.

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<sup>51</sup>Generally, regarding deferral in foreign controlled corporations and the use of intermediaries, see Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis*, supra footnote 28, pp. 474-85, and Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 296-312 and 388-415. Regarding the corporate tax shelter issue generally (including from a domestic perspective), see Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra footnote 38, pp. 144-69.

<sup>52</sup>Generally, see chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

For many years, the largest group of target shareholders subject to anti-deferral rules has been corporate shareholders, particularly parent corporations of controlled foreign subsidiaries. The rationale for taxing such corporations immediately on the profits of their subsidiaries was in order to prevent the avoidance of residence country taxation.

However, at a conceptual level, the taxation of corporations is a method of taxation at source, particularly the taxation of the corporation's shareholders. From this perspective, the application of controlled foreign corporation rules to parent corporations is a method of preventing deferral of residence country taxation by the parent corporation's shareholders. Increasingly, resident corporations are not owned solely by resident shareholders, at least not taxable ones. Indeed, there are many corporations, particularly widely held corporations, which are majority owned by tax exempt institutions (such as pension funds) and non-resident persons (including sovereign wealth funds).

In a globalizing world, with increasing fragmentation of shareholders, there is evidence that the application of controlled foreign corporation rules is having an increasing effect on the location of the parent corporation's residence. Application of controlled foreign corporation rules by residence countries makes less sense if a parent corporation's shareholders are not subject to residence country taxation in the same jurisdiction as the parent corporation. In the future, residence countries that wish to address the deferral issue may find that they need to target their anti-deferral rules more precisely at the persons (often high-wealth resident individuals) that are subject to residence country taxation.

#### **4. General issues in administering the taxation of foreign source income**

There are four core areas of tax administration — collection of information, assessment, dispute resolution and collection of tax.<sup>53</sup> Thus far,

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<sup>53</sup>Generally, regarding tax administration with respect to cross-border taxation of income, see Peter A. Harris and David Oliver, *International Commercial Tax*, supra footnote 14, pp. 452-66. For a comparative analysis of these four areas, see OECD (2013), *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*, particularly at pp. 289-329.

the focus has been on the rules (especially tax treaty rules) that must be used in making an assessment of tax due to the residence country with respect to foreign source income. However, issues pertaining to tax administration procedure, and whether there are any particular issues, regarding these core areas of tax administration raised by residence country taxation of foreign source income, have not been considered directly.

#### **4.1 Collection of information**

Tax administrations typically have broad general powers to access information for purposes of making or checking tax assessments. This access may be either voluntary (for example, by the taxpayer submitting a return) or forced (for example, audit powers). These aspects of information collection are often related, the main reason being that taxpayers will voluntarily disclose information because they know that if they do not the tax administration has the right to collect the information directly and impose penalties for failing to do so. Accordingly, if the power of the tax administration to force information collection on the taxpayer is not available, there is an increased risk that the taxpayer will not voluntarily disclose.

In the context of foreign source income of residents, the main issue with respect to voluntary disclosure is the type of information that the taxpayer is required to disclose. As for forced disclosure, the main issue is how to achieve this with respect to information that may only be available in a foreign country. Each of these issues is now considered in turn.

##### **4.1.1 Type of information to disclose**

A person is likely to be required to declare information as to foreign source income in the person's tax return irrespective of the method adopted by the residence country for the elimination of double taxation. Some of this information will be generic in nature and reflect the information required with respect to domestic source income. This type of information may include a declaration as to the quantum of income, the character of the income (that is to say, whether it is business profits, dividends, interest, capital gains, etc.) and the related deductions claimed.

In addition, further information will be required because of the nature of the income as foreign source income and the effect of the treaty provisions previously mentioned. In particular, most residence countries treat foreign source income differently, depending on the country from which the income is derived, and this is particularly a consequence of the bilateral nature of tax treaties. Therefore, it will be necessary for a taxpayer to declare the country in which the income is sourced and the type of relief for elimination of double taxation being claimed (if any). The latter may require the taxpayer to identify the precise treaty under which relief is claimed (and the basis upon which the taxpayer claims the benefit of that treaty) or whether unilateral relief is claimed (if available).

Where tax treaty relief is claimed the situation may be more complex. As noted in section 2.2, tax treaties incorporate a schedular system, but that system is unlikely to match precisely the domestic characterization of income according to which the taxpayer will be required to declare income. It is not realistic that a residence country has a specific form of tax return for every country with which it has concluded a tax treaty. Rather, a generic form must be used that has scope for inclusion of information relevant to the applicable treaty. The tax returns of most countries require foreign source income to be declared in a specific part of the return form, separate from that for domestic source income. It is likely that it is the domestic rules for determining source that are used for declaring foreign source income rather than any inherent source rules incorporated in a particular treaty.

From here, tax returns are likely to provide a flexible mechanism for inclusion of further information relevant for the application of the particular relief claimed, whether treaty or unilateral relief. As mentioned, this information is likely to require identification of the tax treaty under which relief is claimed or if unilateral relief is claimed. It may also require identification of the article of a tax treaty under which the source country may tax this income. For example, this is important where the residence country adopts the exemption method under the treaty because, as outlined in section 2.1, the exemption method is typically only available where the source country has a right to tax under particular articles of the treaty (such as the articles dealing with immovable property, business profits and employment income). This may also be important for purposes of the credit method because

the residence country is only required to credit tax that is properly levied by the source country under the treaty and that will depend on the provision under which the source country taxes (for example, the source country's right to tax is different for dividends and interest).

The type of information described above may be sufficient for purposes of applying the exemption method, including exemption with progression. Further information will be required where the residence country adopts the foreign tax credit method. In particular, the residence country will require information as to the amount of foreign tax imposed on particular items of foreign source income. For the reasons described in the preceding two paragraphs, the allocation of particular foreign tax to particular foreign source income could in some cases be complex. In the case of unilateral relief, source country tax will have been imposed with respect to the source country's classification of income. This source country tax must be reallocated to income as classified by the residence country. This will happen if the schedular or global income calculation system in the source country is not the same as that in the residence country.

The application of tax treaties can make this conversion process more complex for foreign tax credit countries than in the case of unilateral relief. This is because the tax imposed by the source country has to be allocated to income as classified under particular provisions of a tax treaty. The residence country must then reallocate that tax to its own domestic classification of income. There can be no hard and fast rules in this regard and each foreign tax credit country is likely to adapt a system to its own circumstances. However, in perhaps the vast majority of cases faced by a residence country tax administration the reallocation process will be straightforward.

#### **Box 14**

##### **Interface of schedular systems: Domestic laws and tax treaties**

A resident of Country B conducts activities in Country A. Under Country A domestic law, income from all business activities is aggregated. For the current year, Country A considers that the resident has 100 profits and all the activities are business activities. It includes in the calculation rent from immovable property of 60 and a payment of 80 received on termination of a position as officeholder in a public corporation in Country A.

Country A taxes the profits at the rate of 25 per cent. Country B requires taxpayers to calculate their income separately for income from immovable property and considers an officeholder an employee. It also taxes the resident at 25 per cent, but offers a foreign tax credit calculated on a slice-by-slice basis, and quarantines foreign losses on a similar basis. There is a tax treaty between Country A and Country B.

Country B may have difficulty in calculating the foreign tax credit available to the resident. First, it must determine how much of the 25 Country A tax it is obliged to credit under the treaty. Here, it must de-aggregate the profits, and test if Country A has the right to tax under the treaty and, if so, whether Country A has taxed at a rate permitted by the treaty. For example, Country A may tax the rent under Article 6 and so it is creditable, but there will be an issue of how much of the 25 Country A tax paid is attributable to the 60 rent. If the termination payment is effectively connected with a PE or fixed base in Country A, all of the tax attributable to it is also creditable (Article 7 or Article 14), but again there is an issue of quantum. However, if the termination payment is not so connected, then Country A's taxing right may have to be tested against various other provisions of the treaty, including Article 13 (capital gains), Article 15 (employment) and Article 16 (directors' fees). The figures make it clear that some expenses are involved (100 profits is less than the 140 gross rent and termination payment) and these will have to be allocated to the various activities.

Even presuming all of the Country A tax is creditable, Country B may still have difficulty in working out the foreign tax credit available. In particular, for the purposes of its own tax law, it must separate the Country A income (which Country A aggregates) into at least three categories, that is to say, business, immovable property and employment. If Country B has separate taxation of capital gains and all or part of the termination payment is considered a capital gain, it may have a fourth category. Further, these categories may not be the same as under the treaty, such as where the termination payment falls under Article 7 (business profits) or Article 14 (independent services) when its law considers the payment employment income. Further, there is a risk that in the allocation process Country B may find a quarantined foreign business loss, such as where it considers the resident's 100 income is made up of a business loss of 40, immovable property income of 60 and employment income of 80. In this case, Country B's quarantining of foreign losses means there may be additional Country B tax on the property and employment income, despite credit of all the Country A tax and the fact that both countries have the same tax rate.

#### **4.1.2 Forced disclosure**

As a resident taxpayer is within the jurisdiction of the residence country tax administration, there are no legal restraints on requiring the resident taxpayer to declare foreign source income (as mentioned above in section 4.1.1) to the tax administration and demanding that the return be supported with relevant documentation. Failure by the resident taxpayer to declare required information will be met with a penalty under the domestic law of the residence country. As a general rule, most countries collect such penalties in the same manner as taxes, and in this regard the analysis in section 4.4 is relevant. However, a tax administration will not know whether to impose such a penalty unless it can independently verify that the requirements as to declaration of foreign source income have not been met. This is the power of audit, which requires the use of entry, access and forced information gathering powers. The procedure for auditing with respect to foreign source income usually follows the same procedure and time limits as for domestic source income.

The use of forced information gathering powers by a residence country tax administration with respect to foreign source income raises serious jurisdictional issues. This is especially the case if the relevant information is beyond the physical jurisdiction of the residence country. The legal power of tax administrations to access premises, documents and other information is most always jurisdictionally unlimited. That is to say, a tax administration will have a right according to its own country's law to access information wherever it is located, including in a foreign country. However, in the absence of agreement with a foreign country (for example, through a treaty) the tax administration of a particular country is likely to breach the law of the foreign country (either its general criminal law or a specific law, such as with respect to confidentiality) if it tries to exercise its information gathering power there. Further, tax administrations often have strict limits on their right to delegate administrative powers to other institutions, whether the delegation is to a local institution or a foreign institution such as a foreign tax administration. Accordingly, in the absence of an express power, a particular tax administration may not even be able to request that a foreign tax administration provide assistance in the collection of information.

Even if a particular tax administration has domestic power to request assistance from a foreign tax administration in the forced collection of information, it is unlikely that (in the absence of a treaty) the foreign tax administration could comply with the request. This is because the foreign tax administration will have been established for the purposes of administering local taxes (not foreign taxes) and its powers, including its information gathering powers will have been granted exclusively for that purpose. This means that in almost all cases the foreign tax administration will have no domestic legal power to collect information for the enforcement of foreign tax laws.

Therefore, when it comes to enforcing residence country tax consequences of a resident taxpayer deriving foreign source income, lifting these limitations on the exchange of information with the source country tax administration is critical. The potential for this exchange and easing these limitations is facilitated by tax treaties and, in particular, Article 26. Article 26 (1) permits the competent authorities of the treaty partners (typically the tax administrations) to exchange information “as is foreseeably relevant for carrying out the provisions” of the treaty. It also permits exchange for the “administration or enforcement of domestic laws concerning taxes of every kind and description”, whether imposed by the treaty partners, their political subdivisions or local authorities. Accordingly, the power to exchange information is substantially broader than the taxes covered by the distributive rules of tax treaties. Further, there is no requirement that the person with respect to whom the information is requested be a resident of either contracting State.<sup>54</sup> The United Nations Model Convention provides for the competent authorities to develop procedures for exchange of information through consultation.<sup>55</sup>

Exchange of information typically takes one of three different forms.<sup>56</sup> It may be provided to comply with a request of the competent

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<sup>54</sup>For example, see paragraph 8.2 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>55</sup>Article 26 (6) of the United Nations Model Convention.

<sup>56</sup>For example, see paragraph 5.4 of the Commentary on Article 26 of the United Nations Model Convention and the Inventory of Exchange Mechanisms at paragraph 30. In 2006, the OECD published a Manual on Information Exchange, available at <http://www.oecd.org/ctp/exchange-of-tax-information/cfaapprovesnewmanualoninformationexchange.htm>.

authority of the treaty partner. Some information may be provided automatically and this is particularly the case with computer-generated records. Thirdly, the competent authority may provide information on its own initiative, that is to say, spontaneously, such as where it feels that the competent authority of the treaty partner may view the information as relevant. Automatic exchange of information is particularly topical, especially in the context of residence country taxation of foreign source income.<sup>57</sup> Large sums of foreign source income find their way into foreign bank accounts and Article 26 (5) of both the United Nations and OECD Model Conventions specifically states that where information has been requested of a competent authority, that competent authority cannot withhold the information solely by reason that it is held by a bank or financial institution.

Historically, because Article 26 is located in tax treaties, exchange of information has not been available in the absence of such a treaty. This has meant that countries that do not have a broad tax treaty network have limited scope for requesting exchange of information. More recently, this has been remedied through two mechanisms. One is the proliferation of dedicated exchange of information agreements based on the OECD 2002 Model Agreement on Exchange of Information on Tax Matters.<sup>58</sup> The second is the 1988 Convention on Mutual Administrative Assistance in Tax Matters developed by the OECD and the Council of Europe.<sup>59</sup> Each of these mechanisms has broad exchange of information provisions. The 1988 Convention has become particularly important since a Protocol came into force in 2012 that both opened the Convention to non-member States and restricted the ability of tax administrations to deny exchange of information

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<sup>57</sup>More recently, OECD Member States and certain other countries have been working on more comprehensive forms of automatic exchange of information. Generally, see <http://www.oecd.org/ctp/exchange-of-tax-information/>. As late as 2009, the United Nations Tax Committee was working on a “Code of Conduct on Cooperation in Combating International Tax Evasion”, in which exchange of information focused on exchange by request.

<sup>58</sup>Available at <http://www.oecd.org/ctp/exchange-of-tax-information/2082215.pdf>.

<sup>59</sup>OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf>.

based on bank secrecy. This Convention has the advantage of providing a multilateral solution to cross-border tax administration issues, including exchange of information and assistance in collection of taxes. It also broadens the scope for bilateral and even multilateral tax audits.

## **4.2 Assessment**

Based on the information collected, a tax law will provide for the making of an assessment or tax decision. These decisions are of two types, either self-assessment by the taxpayer or an administrative assessment, including an amendment of a self-assessment. The procedure for assessment of tax with respect to foreign source income usually follows the same procedure and time limits as for domestic source income. In particular, foreign source income of residents is commonly subject to tax by way of self-assessment, including not only the assessment of the primary tax liability, but self-assessment of the right to elimination of double taxation, whether by exemption or foreign tax credit. Tax treaties do not usually affect the application of domestic assessment rules, although there is a special rule in Article 25 (2) that seeks to extend the assessment procedure where the mutual assistance procedure of the treaty is engaged.

One special issue regarding assessment of tax on foreign source income is the time at which elimination of double taxation becomes available in the residence country. This is particularly important where the foreign tax credit system is adopted, but can also be relevant for an exemption system, for example, where the exemption with progression approach applies. Residence countries commonly require direct evidence that foreign tax has been paid and the assessment upon which it is based. Typically, no foreign tax credit is available until the foreign tax is paid. It is then a question of operation of the foreign tax credit system as to whether the credit is available for the tax year in which the foreign tax is paid, or whether it is available when the income subject to the foreign tax falls into charge, usually the latter.

## **4.3 Dispute resolution**

Once an assessment or tax decision is set or accepted by the tax administration, there is scope for dispute with the taxpayer regarding,

amongst other things, the quantum of the assessment. Tax laws typically provide two mechanisms for resolving disputes. The first is a review procedure internal to the tax administration, commonly called an “objection” procedure. If the taxpayer and the tax administration fail to reach agreement, there is usually a subsequent independent review. Often this will be to a specialist tax tribunal with the potential for further appeal to the general courts; although in some countries the appeal is directly to the general courts.

When the review procedure is projected into an international setting, often there are two tax administrations and two court systems that may engage in review of taxation of foreign source income, that is to say, those of the source country and those of the residence country. From the residence country’s perspective, the usual objection and court review procedures will apply to an assessment of foreign source income of a resident. The same is likely to be true of a source country assessment of, in its view, domestic source income of the non-resident. These procedures of the source and residence countries are independent of each other and won’t necessarily resolve issues of double taxation (or double non-taxation). However, tax treaties provide potential for unified or coordinated administrative review in an international setting. The primary benefit of such a review is that, as it involves the authorities of both countries concerned, the taxpayer may be provided with a holistic solution to double taxation.

Article 25 provides for coordinated review by the competent authorities of the contracting States of taxation covered by a tax treaty (the “mutual agreement procedure”).<sup>60</sup> This procedure may be viewed as a logical extension in a bilateral setting of the typical internal review (objection) procedure adopted by most tax administrations domestically. In the case at hand, where a resident taxpayer believes that they have been taxed with respect to foreign source income in a way that is inconsistent with a tax treaty, the taxpayer can instigate the mutual agreement procedure by approaching the tax administration of the residence country.<sup>61</sup> This does not exclude the taxpayer’s right to pro-

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<sup>60</sup>For more details regarding the mutual agreement procedure, see chapter VIII, Dispute resolution: the Mutual Agreement Procedure, by Hugh J. Ault.

<sup>61</sup>Article 25 (1) of both the United Nations and OECD Model Conventions.

ceed with a dispute in the court system of the residence country (or that of the source country). However, many tax administrations are reluctant to take up a taxpayer's case if the matter is being pursued through the domestic courts (and see further below).

Where the residence country competent authority (usually the tax administration) cannot resolve a case of double taxation presented to it, that competent authority is obliged to approach the competent authority of the other State with a view to resolving the issue bilaterally.<sup>62</sup> The residence country competent authority is only required to "endeavour" to resolve the case with the other competent authority and so the authorities are not bound to agree to a solution. This is consistent with the internal review procedures of most countries. Indeed, a residence country may apply the procedural rules of its internal review procedure to the mutual agreement procedure.<sup>63</sup> However, Article 25 does include some procedural rules, such as that the taxpayer must present the case to the residence country competent authority within three years of first notification of the taxation, and the United Nations Model Convention makes provision for the development of others.<sup>64</sup>

A legal difficulty with any mutual agreement between competent authorities is whether there is an internal law bar to the effectiveness of the agreement. For example, domestic law time limits may prevent a tax assessment being amended in favour of the taxpayer. Article 25 (2) seeks to overcome this difficulty by prescribing that any agreement reached is to be implemented despite any domestic law time limits. Another difficulty is the interrelationship between any mutual agreement and court decisions. Some countries have an internal law

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<sup>62</sup>Article 25 (2) of both the United Nations and OECD Model Conventions.

<sup>63</sup>For example, see paragraphs 16 and 20 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention.

<sup>64</sup>The second sentence of Article 25 A (4) and Article 25 B (4) of the United Nations Model Convention provides for the competent authorities to develop procedural rules in consultation. Particular procedural issues are discussed at paragraphs 20-46 of the Commentary on Article 25 of the United Nations Model Convention. In 2007, the OECD published a Manual on Effective Mutual Agreement Procedures, available at <http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementproceduresmemap.htm>.

provision that gives effect to a mutual agreement even if it is contrary to a court decision, but, in others, the internal law does not permit the mutual agreement to override a court decision. The normal procedure would be for the mutual agreement to bind the tax administration, but not the taxpayer, much in the same manner as a tax rulings system. This would leave the taxpayer open to challenge the agreement in the courts. To prevent any potential inconsistency, it is common for implementation of a mutual agreement to be subject to acceptance of the agreement by the taxpayer and settling of any court proceedings.<sup>65</sup>

Most commonly, the mutual agreement procedure is used in disputes over whether a source country has taxed in accordance with a tax treaty, and transfer pricing disputes are the most common subject of this procedure.<sup>66</sup> These sorts of disputes are also important for residence countries. For example, assume that the resident taxpayer has a PE in the source country which it believes has been taxed beyond what is permitted by Article 7 of the relevant treaty. The residence country adopts the foreign tax credit method for elimination of double taxation and the source country taxation is more than taxation in the residence country (that is to say, it engages the limitation on credit). The resident may approach the competent authority of the residence country and this may result in a mutual agreement procedure. If source country taxation is reduced as a result of that procedure, this will have an impact on the manner in which the residence country calculates the foreign tax credit.

A similar example is where a resident corporation has a subsidiary in the source/host country and the source country makes a primary transfer pricing adjustment under Article 9 (1). The corresponding

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<sup>65</sup>See paragraph 45 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention and footnote 49 at paragraph 42 of the Commentary on Article 25 of the United Nations Model Convention. See also paragraphs 76 and 82 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 18 of the Commentary on Article 25 of the United Nations Model Convention.

<sup>66</sup>Regarding common types of disputes, see paragraph 9 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention.

adjustment (see section 1.3.2) required of the residence country under Article 9 (2) is a common subject of the mutual agreement procedure. Another common subject for mutual agreement is determination of the appropriate article under which a source country can tax. As source country taxing rights vary depending on which article of a tax treaty is applicable, this will also have an effect on a residence country's obligation to eliminate double taxation.

A major issue with the mutual agreement procedure has been the lack of a requirement for the competent authorities to reach agreement. In recent years, this has been addressed in both the United Nations and OECD Model Conventions through the inclusion of an arbitration procedure.<sup>67</sup> The United Nations Model Convention provision applies where the competent authorities fail to reach an agreement within three years after the presentation of the case by one competent authority to the other. This is not an independent review of the taxpayer's issues, but merely an extension of the mutual agreement procedure. The taxpayer has no express right to participate in this arbitration and in the United Nations Model Convention version the arbitration can only be instigated by one of the competent authorities. There is no requirement that the arbitrators be independent; they may well be tax officials of the competent authorities. The taxpayer is not bound by an arbitrator's decision.<sup>68</sup>

#### **4.4 Collection of tax**

Finally, at least when the assessment or tax decision is not disputed (or not capable of dispute), there is the issue of collecting tax or enforcing the decision. Here again, there are usually two mechanisms. There is collection directly from the taxpayer and the taxpayer's assets. Secondly, the tax laws of most countries also provide for situations in which recovery may be from a third party, for example, a person owing

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<sup>67</sup>Article 25 B (5) of the United Nations Model Convention and Article 25 (5) of the OECD Model Convention. Alternative A of Article 25 of the United Nations Model Convention does not contain an arbitration provision.

<sup>68</sup>See paragraph 76 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 18 of the Commentary on Article 25 of the United Nations Model Convention.

money to the taxpayer, such as a bank. Like other powers of the tax administration, the power to collect taxes and the mechanisms that may be used are a matter of domestic law.

In the context of foreign source income of residents, often the residence country has the taxpayer and local assets physically within its jurisdiction for purposes of enforcing a tax assessment. However, there will be cases where a resident person has few assets in the jurisdiction and the person is not physically available for enforcement, for example, in cases of artificial entities or where an individual has taken flight. Here the general position is the same as described in section 4.1 in the context of collection of information, that is to say, irrespective of what the domestic law of the residence country provides, its tax administration will not be able to collect its taxes in a foreign country. Further, in the absence of legislative authority, most tax administrations are not empowered to collect the taxes of a foreign country requesting assistance.

Article 27 of both the United Nations and OECD Model Conventions provides for mutual assistance of competent authorities in the collection of taxes. Like Article 24 on non-discrimination and Article 26 on exchange of information, Article 27 is not limited to taxes covered by the distributive rules of the particular treaty. While an assisting tax administration will continue to use its domestic tax collection powers when providing assistance, the competent authorities are to settle by mutual agreement the mode of application of the Article.<sup>69</sup>

Article 27 (3) provides for a competent authority to request of the other competent authority assistance in the collection of a revenue claim. A request may be made only if the taxpayer cannot “prevent” the collection of the claim under the laws of the requesting country. The other competent authority is then to collect the claim “in accordance with the provisions of its laws applicable to enforcement and collection of its own taxes ...”. Article 27 (4) makes similar provision for assistance in preemptive measures in the collection of revenue claims,

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<sup>69</sup>In 2007 the OECD published a Manual on Implementation of Assistance in Tax Collection, available at <http://www.oecd.org/ctp/exchange-of-tax-information/oecdmanualonassistanceinthecollectionoftaxes.htm>.

referred to as “measures of conservancy”. Under Article 27 (8), a contracting State is not required to assist unless the requesting State has “pursued all reasonable measures of collection ... under its laws or administrative practice ...” or where the “administrative burden ... is clearly disproportionate” to the taxes to be collected.

Under Article 27, a residence country seeking to collect tax with respect to foreign source income of its residents may request assistance with that collection of the source country. However, Article 27 is general in nature. The residence country may make such a request of any country (with which it has a treaty with a provision on assistance in collection) that may be able to provide that assistance, such as a country where the person has substantial assets.

The OECD/Council of Europe-sponsored 1988 Convention on Mutual Administrative Assistance in Tax Matters was dealt with in section 4.1.2 in the context of exchange of information. This Convention also includes provisions on assistance in recovery of taxes (Articles 11-16), which were influential in the drafting of Article 27 of both the United Nations and OECD Model Conventions. Again, an advantage of this Convention is that it provides a multilateral solution to cross-border tax administration issues, including assistance in collection of taxes.



## Chapter IV

### Taxation of non-residents

COLIN CAMPBELL\*

#### 1. Introduction

##### 1.1 Scope of the chapter

This chapter considers the issues faced by developing countries where a person, who is not resident for tax purposes in a State (a non-resident) under the domestic law of that State (the source State), has activities either in, or with residents of, the source State, which attract tax liability under the tax law of that State, and is a resident of another State with which the source State has a bilateral tax treaty. For these purposes, only taxes on income addressed in tax treaties<sup>1</sup> will be considered. The issues arising in these circumstances include determining if the non-resident is entitled to benefits under the treaty and, if so, how these benefits are delivered, whether by refunding to the non-resident amounts paid or withheld in excess of the treaty-mandated amounts, or by reducing amounts paid or withheld to reflect reduced rates of tax provided under the treaty. A further issue, unrelated to the collection of tax from non-residents, arises out of the mutual obligations contained in most, if not all, tax treaties on each contracting State to provide to the other State information relevant to the administration of the tax system of that State and, in some cases, to provide assistance in the collection of taxes.

Because the treaty may have an impact on the domestic tax law provisions applying to non-residents of the source State generally, this chapter will begin with an overview of the administrative provisions typically used in connection with taxing non-residents.

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<sup>1</sup>Otherwise than in connection with exchange of information issues discussed below.

The following types of income will be considered:

1. Passive investment or portfolio income derived from the holding of property giving rise to interest, dividends or royalties paid by a person or entity in the source State.
2. Income from a business of providing services, whether or not attributable to a fixed base or permanent establishment of the non-resident in the source State.
3. Income from carrying on other businesses, whether or not attributable to a permanent establishment of the non-resident in the source State.
4. Income from providing services as an employee which are exercised in the source State.
5. Income from gains realized by the non-resident in the source State.

The application of tax treaties to some of these types of income is discussed in detail in other chapters of this Handbook.<sup>2</sup>

## **1.2 Ensuring compliance with domestic tax law by non-residents generally**

For the purposes of this chapter, it is assumed that the domestic laws of the source State impose tax on non-residents earning income sourced in that State and that there are administrative measures in place to enforce compliance with the domestic law. Typically, these measures will have three principal elements:

### **(a) Identification of non-residents:**

The first step in taxing non-residents on income derived from the source country is the identification of such non-residents. This identification requires the source country to have good information and depends on the type of income derived. Where

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<sup>2</sup>See chapter V, Taxation of non-residents on business profits, by Jinyan Li; chapter VI, Taxation of non-resident service providers, by Ariane Pickering; and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

the income-earning activities consist of carrying on business or exercising employment by a non-resident directly in the source country, the non-resident will typically be required to obtain a taxpayer identification number or to otherwise register either with the tax authorities or with some other governmental authority in the source State. These registration requirements may be enforced through border or other immigration controls, through exchange controls, in connection with social security or healthcare regimes, or as part of the general regulation of business activity. In the case of non-resident recipients of investment income flows (interest, dividends or royalties) from the source country, identification of the non-resident is less important than the identification and registration of the resident payer, because such amounts are typically taxed by means of source withholding by the payer in the source State.<sup>3</sup> This may also be the case with respect to certain capital gains realized by non-residents, where a resident purchaser of the property disposed of may be required to withhold from the sale proceeds of the property.

(b) Information gathering and reporting:

Information about non-residents deriving income from the source country is necessary not only to identify such non-residents, but also to determine the amount of income and the tax payable. In general, such information is obtained by requiring non-residents to file tax returns or information forms containing prescribed information. With respect to investment income, the necessary information is usually obtained from the withholding agent or resident payer. Information may also be obtained from third parties, such as financial institutions, and from foreign tax authorities pursuant to the exchange of information provision in tax treaties, as discussed below.

Normally, a non-resident who carries on a business in the source country, whether by providing services or otherwise, will be

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<sup>3</sup>See the discussion on identification of relevant non-resident taxpayers in chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold, at section 7.2.

required to file a tax return in which the profit of the business and the amount subject to tax is calculated and supporting information is provided. A non-resident providing employment services in the source country may also be required to file a return. In addition, the employer will likely be required to withhold interim tax from the employee's salary or wages and provide relevant information to the tax authorities. Where the domestic law allows the deduction of expenses incurred to earn the income, which is usually the case for business profits and sometimes the case for income from employment, the non-resident may be required, but will generally be motivated, to file a return claiming such expenses.

For passive investment income derived by a non-resident in the source country, the primary return will be made by the resident payer and will usually disclose the nature of the amount paid to the non-resident, the name and address of the recipient, and the amount of tax withheld. A non-resident recipient of passive investment income will normally be taxed on a gross basis by way of a final withholding tax<sup>4</sup> and no tax return would be required. A non-resident realizing a capital gain will typically be required to file a return calculating the gain net of the cost of the property plus any allowable expenses and the tax payable.

(c) Collection of tax payable:

In order to enforce payment of tax and to provide a balanced cash flow to the Government of the source State, recipients of passive investment income and employment income are normally subject to withholding at source by the payer in the source country. Because investment income is typically taxed on a gross basis and deductions allowable in computing employment income are often immaterial, the amount withheld

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<sup>4</sup>The term "final withholding tax" is used because the non-resident is not required to file a tax return and the amount withheld is the only tax imposed. Withholding at source is also used as an interim measure. However, in the case of interim withholding, the amounts are withheld on account of tax payable and the taxpayer is required to file a tax return to determine if additional tax is payable or if a refund is available.

will normally approximate the actual tax liability of the non-resident. Source withholding is also often applied to amounts paid to non-residents carrying on a business of providing services. This is an effective means of enforcing payment of the tax where the presence of the non-resident in the source country is transitory. It may also roughly approximate the actual tax liability of the non-resident if the expenses incurred in earning services income are relatively small. Special arrangements may be necessary in the case of certain non-residents providing services, such as artistes and sportspersons.<sup>5</sup> In the case of business income, the non-resident will normally be subject to the ordinary domestic tax collection measures, including recourse, where necessary, to assets of the non-resident held in the source country. In the case of capital gains, a resident purchaser may be required to withhold a portion of the purchase price on account of any tax payable by the non-resident vendor. However, the determination of the amount to be withheld is complicated by the fact that the purchaser will know only the purchase price and not the net gain. If the property is sold by one non-resident to another, it is difficult for the source country to impose an obligation on the purchaser to withhold.

### **1.3 The connection between tax compliance and source withholding**

The single most important factor bearing on the compliance by non-residents with domestic tax law is the use of source withholding by the source State. Withholding tax from the payment by a resident or enterprise of the source State to the non-resident both ensures payment of all or part of the tax liability of the non-resident and provides a strong incentive to the non-resident to comply with domestic reporting requirements in any case where the source withholding exceeds the tax liability. While there may be some concern that source withholding, particularly where there is undue delay in processing claims for refunds by the source State, may act as a disincentive to investment or other business activity in the source State by non-residents, there

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<sup>5</sup>See the discussion in chapter I, *supra* footnote 3, at section 7.3.2, on the treatment of artistes and sportspersons.

are two arguments against that view. In the first place, such withholding regimes are widely, if not universally, used in developed countries and are thus not unfamiliar to potential investors. Secondly, the undoubted benefits of source withholding outweigh the possible loss of economic activity by those non-residents who would seek to avoid paying tax in the source State. There is therefore a major role for source withholding in ensuring both reporting and payment.

The use of final withholding taxes to collect tax from non-residents is widespread and recognized internationally as a legitimate mechanism to collect tax. It should be noted, however, that such taxes are a proxy for a tax on the net income derived by non-residents and may not be appropriate where a non-resident incurs substantial expenses in earning the income. The rate of withholding is obviously critical. In some circumstances, non-residents may be able to require the resident payers to bear the burden of the withholding tax by “grossing-up” the amount of the payment. Thus, the withholding tax could have the undesirable indirect effect of increasing the cost of financing, technology and services to residents of the source country.

#### **1.4 Effect of tax treaties**

Tax treaties do not generally impose restrictions on the administrative policies or procedures of a contracting State.<sup>6</sup> Accordingly, the source State should not be restricted by a tax treaty in imposing registration or reporting requirements on non-residents or in imposing domestic withholding requirements (other than the amount of tax) with respect to amounts paid to non-residents.<sup>7</sup> Tax treaties, however, may place various restrictions on the degree to which the source State can tax non-residents who are resident for treaty purposes in the other

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<sup>6</sup>See chapter I, *supra* footnote 3.

<sup>7</sup>Providing such requirements are not imposed in violation of Article 24 (Non-discrimination) of both the United Nations Model Double Taxation Convention between Developed and Developing Countries, (New York, United Nations, 2011) (United Nations Model Convention), and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital, (Paris, OECD, 2010, loose-leaf) (OECD Model Convention), as discussed *infra* in section 7.

contracting State. In some cases, income otherwise taxable will be exempt from tax under the treaty (for example, business profits not attributable to a permanent establishment). In other cases, the rate of tax will be limited under the treaty (for example, tax on interest, dividends or royalties). This places additional administrative burdens on the source State, namely determining whether a particular resident is eligible for treaty benefits, identifying the income source, which is affected by the treaty, and putting in place arrangements for either reducing or eliminating source withholding to reflect reduced treaty rates of tax or for making timely refunds where tax has been withheld at higher than the treaty rate. As a result, the non-resident may be subject to different or enhanced reporting to allow the tax authorities to effectively apply the treaty.

The remainder of this chapter considers specific aspects of the effects of the treaty obligations assumed by the tax administration of the source State with respect to the taxation of non-residents.

## **2. Registration requirements for non-residents**

Many countries use taxpayer identification numbers for residents in order to make the assessment and collection of tax more efficient. Such numbers can also be used for non-residents and, in particular, those who are carrying on business in a country. The assignment of a taxpayer identification number can be part of the business registration of non-residents.

The obligations imposed by a tax treaty on a source State to give non-residents such favorable treatment as is mandated by the treaty reinforces the need for a comprehensive tax roll, which identifies both non-residents carrying on business in the source State and resident payers of salaries or wages, dividends, interest, royalties and other amounts to non-residents. If it is possible to combine registration for tax purposes with any registration required for general business or regulatory purposes, there may be administrative efficiencies and it may be easier for the tax administration of the source State to access information about the activities of the non-resident, which would be relevant in determining its treatment under the treaty. Registration could require non-residents to provide information about the type of,

or manner of carrying on, the business of the non-resident. In a federal State, or a State where general business registration may be carried out at the regional or municipal level, consideration may have to be given to co-ordinating registration with the national (or even regional) tax authorities.

While registration for tax purposes will include contact information for the non-resident status, the registration document may not disclose the actual residence of the non-resident, nor contain information necessary to determine whether the residence of the non-resident constitutes residence for treaty purposes. It is doubtful that the registration process should be used to determine residence for treaty purposes. In fact, determination of treaty residence at that stage may slow registration and thereby hinder imposition of tax on non-residents generally and may also discourage economic activity by them. These difficulties may be magnified where non-tax administrators are involved in the registration process.

As noted above, registration is primarily required for non-residents carrying on business in the source State. Because source withholding will be the primary method for assessing and collecting tax on dividends, interest or royalties and on income from employment, registration of resident payers of such amounts is necessary in such cases.

Capital gains present somewhat different issues. Where the purchaser of the property disposed of by the non-resident, which gives rise to a gain, is resident in the source State, the domestic law registration and reporting provisions can be used to require reporting and, where appropriate, withholding by the purchaser. Where the purchaser is another non-resident, it may be possible to use indirect methods of identifying the purchaser, such as confirming non-residence status when the sale transaction is subject to domestic registration, reporting or transfer tax requirements, as would typically be the case with respect to real property transactions. In such cases, domestic private law provisions may require co-ordination with the relevant tax provisions. For example, registration of a change of ownership might be denied unless the non-resident purchaser identifies the vendor and, where the vendor is, or appears to be, a non-resident, withholds a portion of the purchase price. Because, under typical treaty provisions, gains from disposals of personal property by a resident of a treaty State

are exempt from source-State tax, the most difficult situations may involve sales of real property disguised as sales of personal property, for example, shares of a corporation whose value derives principally from real property. Where such gains are taxable in the source State, identification and collection of tax may be problematic. It is obviously important that the treaty apply to such situations, as is the case under Article 13 (4) and (5) of the United Nations Model Convention.

### **3. Appointment of local representatives or agents**

The appointment of a local representative or agent by a non-resident of a treaty State may assist in the reporting and collection process because such persons can be required, under domestic law, to report relevant information and transactions and to withhold where payments to the non-resident are made through the agent or representative. While general reporting and withholding obligations may (and should) be placed on all payers in the source State, agents and representatives of the non-resident are likely to be more knowledgeable about the relevant facts and less able to avoid responsibility. Where appointments of such agents or representatives are required for general law purposes, efforts should be made to provide the registration information to the tax authorities and to integrate that information in the general tax roll.

A secondary issue is whether the agent or representative of a non-resident should be able to determine the treaty residence status of the non-resident for the purposes of an applicable treaty and, therefore, to withhold at the lower applicable treaty rate. There is no obvious, or perhaps easy, answer to this question. An agent or representative may have sufficient knowledge to determine treaty residence with a high likelihood of accuracy. In that case, and where the agent or representative is not facilitating avoidance of tax by the non-resident, giving such discretion will significantly ease the administrative burden on the tax authorities and eliminate inevitable delay in assessing refund claims, in turn, removing a disincentive to inbound investment in the source State. These advantages must be balanced against the risk of revenue loss by improper residence determinations and the ability of the tax authorities to penalize delinquent agents or representatives and to recover withholding shortfalls.

#### **4. Procedures for claiming treaty benefits under various methods of assessment and collection**

##### **4.1 Filing tax returns**

Domestic tax law provisions would normally require the filing of a return where tax is imposed on a net amount that must be calculated and reported in the return. This would include business income of all kinds and, in most cases, capital gains where the cost basis and expenses of sale may be relevant in computing the amount subject to tax. In tax systems where deductions are allowed in computing employment income, returns will be required to report net employment income. In all of these cases, the return may also be used to claim treaty benefits, either to reduce tax otherwise payable or to claim refunds where source withholding in excess of tax payable has been made. In order to facilitate assessment of the claim, the return should require the identification of the relevant treaty and, if possible, the particular article of the treaty relied on. The non-resident should be required to state the basis for reliance on the treaty, which will generally be residence as defined in the treaty, and the basis for reliance on the particular treaty article.

Because residence for treaty purposes generally turns on liability to the most general types of tax imposed in the purported residence State, the best evidence may often be a certificate or other statement from the tax authority in that State that the non-resident is liable to tax there by reason of one of the stated criteria or is otherwise a tax resident of that State. This might be accompanied by a copy of a recent tax return consistent with that status. While evidence of legal residence status or other evidence of physical residence might also be tendered, those factors are not necessarily determinative of treaty residence. Alternatively, the source State may directly request confirmation of residence status from the tax authorities of the other State under the exchange of information provisions of the relevant treaty.<sup>8</sup> If the source State requests or requires certification from the tax authorities of the other State, it can expect to be required to provide similar certification for its own residents who, in turn, claim treaty benefits

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<sup>8</sup>See *infra* section 5.

in the other State. Although residence certificates issued by the tax authorities of the other country are useful, they should not be treated as binding on the source country.

In the case of interest, dividends and royalties, the non-resident must also demonstrate beneficial ownership of the amounts in question.<sup>9</sup> While beneficial ownership may also be the subject of an information request to the tax authorities of the other State, an independent investigation may be necessary because that State may use a different definition of beneficial ownership for these purposes. Facts relevant to the determination of beneficial ownership, however, may be obtained from the other State.

Where the non-resident has not been subject to source withholding, tax will almost certainly have been calculated and paid on the basis of the treaty benefit or exemption claimed. Accordingly, any delay in assessing the claim by the source State will result in delay in collecting tax owed if the treaty benefit is ultimately denied. For this reason, it is important that the domestic law provide for payment of interest on tax unpaid at the due date, regardless of delays in assessment. Conversely, interest should be payable on refunds delayed because of delays in assessing treaty claims. Provision of such refund interest should mitigate any concerns that possible excess withholding will discourage investment and business activity by non-residents. Delays, in turn, will increase the likelihood of difficulty in collecting tax assessed. This underscores the importance of source withholding wherever possible.

Although withholding at source is not generally applicable in the case of income derived by a non-resident from a business carried on in the source country other than a business of providing services,<sup>10</sup> consideration might be given to requiring some withholding in respect of payments to non-residents by government or other public bodies under construction or consulting contracts with non-residents. Such

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<sup>9</sup>See chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler.

<sup>10</sup>As noted above in section 1.2, because expenses represent a smaller proportion of gross revenue in some service businesses, and because non-resident service providers may have only a transitory presence in the source State, source withholding is often both practical and desirable in those cases.

payments should also be reported to the tax authorities. Consideration could also be given to requiring major contractors on such projects to report payments made to subcontractors who are, or appear to be, non-residents. Withholding rates could be set sufficiently high to create a real incentive for non-residents to report and claim treaty benefits, but not so as to cause cash flow problems or act as a disincentive to carrying on business in the source State.

It is noted that claims of treaty residence are unlikely to be significant in the case of employment income, except where the employee is employed by a non-resident employer without any permanent establishment in the source country, in which case the employee will be exempt from source-country tax if the employee is present in the source country for 183 days or less.<sup>11</sup> Otherwise, under a typical treaty, non-resident employees will be taxed wholly or largely in the source State on their income from employment exercised in that State. Returns will be relevant only for claiming deductions or other applicable credits under the domestic law provisions. The same is true for dispositions of real property.

## **4.2 Administrative waivers**

Where source withholding is required, the non-resident or the resident payer required to withhold may be given the opportunity to obtain a waiver or ruling from the tax authorities of the source State confirming the appropriate withholding rate or exemption. The application for such a waiver or ruling is subject to the same issues as the assessment of treaty claims in a tax return and the same information or evidence should be required. Where the waiver or ruling is obtained, it may be desirable to require a reference to the ruling in any return made by the payer or in the return, if any, which is ultimately filed. Such an application raises the same issues of demands on administrative resources and delay, but may be useful where repeated payments to the non-resident are likely. Consideration should be given to requiring the renewal or refreshing of such waiver claims from time to time to ensure they remain current.

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<sup>11</sup> Article 15 (2) of both the United Nations and OECD Model Conventions.

### **4.3 Information provided to resident payers**

As an alternative to providing administrative waivers or rulings, the source State might rely on resident payers to request information from non-resident recipients and make their own judgment on the applicability of any treaty claim for reduced or no withholding. While this is cheaper and almost certainly faster, it is satisfactory only if the resident payers are sufficiently diligent and knowledgeable to properly assess the treaty claim asserted. In addition, domestic law measures will be necessary to penalize resident payers who fail to make the proper withholding, including through mistake or negligence in assessing treaty claims. Typically, such a delinquent payer would be liable for the amount which should have been withheld, together with interest and a penalty depending on the nature of the default.

### **4.4 Refund claims**

Dealing with refund claims by non-residents raises the same considerations of time and resources as dealing with requests for waivers or rulings or assessing claims for treaty benefits in a return. For the tax authorities the principal issue is ensuring that delay in processing claims does not adversely affect investment in the source State.

## **5. Information gathering**

### **5.1 Typical treaty provisions**

Typical treaty provisions for the exchange of information<sup>12</sup> require the contracting States to exchange any information “foreseeably relevant” to the administration of any taxes (whether or not covered by the treaty) and in respect of any person (not restricted to treaty residents of either State). They encompass regular, automatic exchanges and exchanges made spontaneously by one of the States but, in most cases, the exchange will occur in response to a specific request from

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<sup>12</sup>See, for example, Article 26 of both the United Nations and OECD Model Conventions, and the Commentaries thereon. See, also, chapter IX, Exchange of information, by Diane M. Ring.

the other State. Article 26 (3) (a) of both the United Nations and OECD Model Conventions, recognizing the open-ended nature of this obligation, provides that the requested State cannot be obliged to act at variance with its laws or the “administrative practice” of it or the other State. Paragraph 16 of the Commentary on Article 26 of the United Nations Model Convention states that Article 26 (3) (a) clarifies that “a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State.” Therefore, this provision prevents conflicts between the domestic law of the State and its treaty obligations.

Article 26 (3) (b) of both the United Nations and OECD Model Conventions provides that a State is not required to provide information “not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State.” The Commentary on the OECD Model Convention<sup>13</sup> states that this condition extends to a State’s failure to provide sufficient administrative resources and that this would entitle the other State to refuse to respond to a request on the basis of reciprocity. The Commentary on the United Nations Model Convention,<sup>14</sup> on the other hand, states that Article 26 (3) (b) is designed to prevent the imposition of “unreasonable burdens” on the requested State and makes it clear<sup>15</sup> that the lack of administrative resources in a State (such as a developing country) does not allow the treaty partner (such as a developed country) to refuse to respond to a request for information on the basis of reciprocity. Paragraph 20.4 of the Commentary on Article 26 of the United Nations Model Convention suggests that the contracting States may wish to address such disparity of administrative capacity explicitly in the treaty.

## 5.2 Exposure to exchange of information requests

Where the administrative resources of a State are insufficient to respond to treaty-based requests for information, it is unclear, absent

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<sup>13</sup>Paragraph 15 of the Commentary on Article 26 of the OECD Model Convention.

<sup>14</sup>Paragraph 20 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>15</sup>Paragraphs 20.3 and 20.4 of the Commentary on Article 26 of the United Nations Model Convention.

specific provisions in the treaty, whether it can decline such requests on the basis of reciprocity, as noted above. Depending on the forbearance of the other contracting State, this lack of reciprocity may impair its ability to get information from the other State to police treaty-based claims by non-residents. Where a State believes such a situation is likely to arise, it may be preferable to deal with the issue directly, either in the course of the initial treaty negotiation or in negotiating subsequent amendments, by clarifying, either by protocol or diplomatic note, the mutual realistic expectations of the parties with respect to exchanges of information.

Any State assuming the treaty obligations with respect to the exchange of information must take steps to ensure that its domestic law provisions with respect to gathering and disclosure of information are broad enough to encompass its treaty obligations. In particular, bank secrecy is no longer an acceptable constraint on a country's ability to exchange information. Most countries have agreed to conform to the international standards on exchange of information, which is being implemented through the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes.<sup>16</sup>

## **6. Assistance in collection**

### **6.1 Typical treaty provisions**

Article 27 of both the United Nations and OECD Model Conventions provides for a potentially broad obligation of a contracting State to collect the unpaid tax debts of the other State. It is not limited to tax debts in respect only of taxes covered by the treaty but extends to any tax the imposition of which is not contrary to the treaty. The requested State is required to collect the tax debt using the same enforcement and collection mechanisms it would use for its own unpaid taxes. Article 27 assumes that the taxpayer in the requesting State has exhausted all avenues that would prevent or delay collection of the amount in question. The substantive validity of the requesting State's claim cannot be litigated again in the requested State.

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<sup>16</sup>For further information, see <http://www.oecd.org/tax/transparency/>.

Both the United Nations and OECD Model Conventions note that the wide-ranging provisions of Article 27 may not accord with the domestic law or the domestic administrative provisions or practice. It is specifically contemplated that in such cases the contracting States may choose not to include such an article in the treaty. In practice, provisions for assistance in collection are still relatively rare and vary widely from treaty to treaty and might be limited to recovery of amounts the payment of which was specifically contemplated in the treaty, or to recovery from tax residents of the requesting State who have assets in the requested State.

A State entering into a tax treaty should consider carefully the benefits and costs of including a collection assistance article in the treaty, given the potential administrative burden involved. This consideration would include some estimate of the amount of unpaid tax, which it might recover through the treaty.

## **6.2 Convention on Mutual Administrative Assistance in Tax Matters**

The Convention on Mutual Administrative Assistance in Tax Matters<sup>17</sup> (sometimes referred to as the “Strasbourg Treaty”) provides for exchange of information, assistance in collection and service of documents, in terms that are generally similar to the OECD Model Convention provisions. A State that is prepared to accept fairly substantial obligations with respect to exchange of information and assistance in collection might consider adherence to the Strasbourg Treaty as a more convenient method of dealing with a fairly large number of countries simultaneously. Its relatively wide scope, however, dictates caution, for the reasons discussed above, relating to the administrative burdens involved.

## **7. Non-discrimination**

Article 24 (1) of both the United Nations and OECD Model Conventions provides that “nationals” of a contracting State shall not be subjected

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<sup>17</sup>The text of the Convention on Mutual Administrative Assistance in Tax Matters is available at [http://www.oecd.org/ctp/exchange-of-tax-information/Amended\\_Convention\\_June2011\\_EN.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/Amended_Convention_June2011_EN.pdf).

in the other State to “any taxation or any requirement connected therewith, which is other or more burdensome” than such requirements applying to nationals of the other State in the same circumstances. The administrative provisions discussed in this chapter should not be considered to be discriminatory under Article 24 (1) for two reasons. In the first place, they would be imposed on the basis of residence, not on status as a “national”. In the second place, most of these provisions, such as source withholding and reporting requirements, are applicable to residents of the source State, not to non-residents. Furthermore, provisions applicable to non-residents, such as tax filing requirements for non-residents carrying on business in the source State or the requirement to apply for refunds, apply equally to residents and to non-residents.

## **8. Anti-avoidance rules**

In general, there should be no conflict between domestic rules designed to prevent tax evasion or inappropriate tax avoidance and the provisions of a tax treaty, given the prevailing view that a treaty should be interpreted broadly to prevent use of the treaty to defeat the object and purpose of its provisions.<sup>18</sup> It would also be possible to specifically exclude domestic anti-abuse provisions from any treaty limitation.

The more difficult issue, particularly for a developing country, is managing the enforcement of complex anti-abuse provisions, such as transfer pricing rules, which require a high degree of expertise and administrative capacity. These rules apply to residents of the source State, but their application typically requires information about transactions with non-residents. If a country has the capability to administer such rules, assuming treaty obligations, such as exchanging information relating to the activities of non-residents in that country, may not place an unreasonably heavy additional burden on the tax authorities. If the country does not have that capacity, adding treaty-related obligations may aggravate the situation.

Generally, one of the difficulties in assessing anti-abuse provisions is their possibly negative effect on investment in the country (or

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<sup>18</sup>See chapter I, *supra* note 3, at section 8, and chapter X, The improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

at least insinuation by non-residents that this would be the case). To the extent that this is a real concern, additional delay caused by a country's administrative difficulty in enforcing such provisions would reinforce that effect. The same issue arises, as noted above, with respect to delays in providing refunds or waivers in the case of withholdings.

## **9. Time limits**

In some instances, a treaty may contain time limitations on the ability of a contracting State to assess or reassess a non-resident that are shorter than those applicable under the domestic law. Because of the additional pressure this places on the tax authorities (and the incentive it creates for the non-resident taxpayer to intentionally delay in the hope of triggering the limitation) a State should consider carefully before agreeing to such a provision. In general, the benefit of having more time to assess should outweigh any additional burden created for its own residents facing audit or reassessment in the other State as a result of the additional time period applying reciprocally. Consideration should also be given to providing in the domestic law of the State longer time limitation periods where the taxpayers are non-residents or where transactions involve non-residents. This reflects the added difficulty and delay in obtaining information, which is often the case with cross-border transactions or non-residents. Such provisions will not be contrary to the non-discrimination provisions of Article 24 of both the United Nations and OECD Model Conventions, if they apply equally to non-residents, such as those carrying on business through a permanent establishment in the source State, and to residents of the source State carrying on the same activities.

## **10. Burden of proof**

Because the taxpayer has the best knowledge of its circumstances, including the transactions it has participated in, and the reasons for entering into them, it is reasonable to impose the initial burden of disproving a proposed reassessment on the taxpayer, as a matter of domestic law. If this is the case in the domestic law, treaty provisions should not reverse that burden (and this would normally not be the case under standard or model treaty provisions). Similarly, the

standard of proof (likely on a balance of probability, but possibly differing in the domestic law) should neither be relaxed for the taxpayer, nor made more demanding for the tax authorities by the provisions of a treaty.

## **11. Conclusion**

Entering into tax treaties raises a number of issues for a developing country, principally related to the demands that a typical treaty makes on the administrative capacity of the country's tax authority. Efforts should be made to identify those demands and the other implications of tax treaties for domestic law prior to entering into treaty negotiations. The development of sufficient expertise to apply tax treaties effectively should be a high priority.



## Chapter V

### Taxation of non-residents on business profits

JINYAN LI\*

#### 1. Introduction

The taxation of non-residents on business profits is important to developing countries in terms of raising revenue and encouraging foreign investment and trade. The source country has the legitimate right to tax business profits arising in its jurisdiction. Tax treaties impose no limits on such taxing rights, other than the obligation to tax net profits (instead of gross profits) in some situations, once the threshold for taxation is satisfied. As such, this source of tax revenue belongs to the source country. There is generally little expectation of the residence country of a non-resident taxpayer in sharing the tax revenue. It is true that the residence country also has a right to tax the profits, but it generally provides a credit for the source country tax or exempts them from tax in order to prevent double taxation. If the residence country provides a credit for taxes paid to the source country, the non-collection of the taxes owed to the source country is a fiscal transfer to the residence country, with no benefit to the taxpayer.<sup>1</sup>

The threshold for the source country to tax the business profits of non-resident taxpayers is the existence of a permanent establishment (PE) through which the business of the non-resident taxpayer is carried on. Ineffective taxation of business profits earned through a PE may lead not only to the loss of revenue from the taxation of a PE, but also potentially the loss of revenue from the taxation of subsidiaries of foreign companies. In cases where a PE and a subsidiary are interchangeable in carrying on business activities in the source country,

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<sup>1</sup>However, if the residence country is an “exemption” country, that is to say, business profits earned in the source country are exempt from taxation, the non-taxation of the business profits in the source country would amount to double non-taxation, which is not intended by tax treaties.

foreign companies would presumably be encouraged to use a PE as opposed to a subsidiary when the profits attributable to a PE are not taxed as effectively as profits of a subsidiary.

The manner in which taxes on business profits are collected and enforced, and the actual or perceived efficiency and fairness in dealing with non-residents may affect the business environment. To non-resident taxpayers, taxes are part of the cost of doing business. Certainty and predictability in tax are perhaps as important as the amount of tax. Therefore, competent tax administration can not only collect the taxes due, but also contribute to a positive business environment for foreign investment. On the other hand, if the tax administration is inefficient or incompetent, causing uncertainty, confusion or aggravation for taxpayers, it may discourage foreign companies from doing business or making investment in the source country.

The taxation of non-residents on business profits presents many difficult administrative issues because different types of business profits are subject to different thresholds for taxation, different sourcing rules and different methods of computation and collection. Unlike source-country taxes on investment income and employment income which are normally collected through withholding, business profits are generally taxed on a net basis, based on self-assessment. Effective tax administration requires adequate resources and procedures. Unfortunately, many developing countries face difficult challenges in this regard.

Following a brief discussion of the ways of obtaining tax information, this chapter analyzes five important aspects of the taxation of business profits derived by non-residents in the source country, namely:

- (a) Identification of the non-resident taxpayer carrying on business in the source country, and of the country in which the particular non-resident taxpayer is resident;
- (b) Tax treaty framework for taxing business profits;
- (c) Whether the non-resident taxpayer is carrying on business in the source country through a PE in that country;
- (d) Attribution of profits to the PE; and
- (e) Collection and enforcement of taxes.

This chapter focuses on Articles 5 and 7 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>2</sup> (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>3</sup> (OECD Model Convention).<sup>4</sup> A thorough discussion of the taxation of services (including the services of artistes and sportspersons) and investment income, which are important types of business profits, is covered under separate chapters.<sup>5</sup> The taxation of other types of business profits, such as transport and immovable property, is mentioned in this chapter to the extent that it is relevant to the understanding of Articles 5 and 7.

## 2. Tax information

Good information is the key to effective taxation of non-residents' business profits in the source country. The tax authorities of the source country need to know which non-residents are carrying on business in their country and whether the business is carried on through a PE. Such determination is highly factual and requires the tax authorities to have good information about the non-resident taxpayer's activities in the source country. Obtaining information from the non-resident or about the non-resident is often challenging. In many developing countries, there may be a serious information deficit.<sup>6</sup> This section briefly deals with ways of addressing such deficit.

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<sup>2</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

<sup>3</sup>Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

<sup>4</sup>Unless specified otherwise, any references to Articles in this chapter are references to the Articles of the United Nations and OECD Model Conventions.

<sup>5</sup>See chapter VI, Taxation of non-resident service providers, by Ariane Pickering, and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

<sup>6</sup>Robert Couzin, "Imposing and Collecting Tax" in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation, 2003), at pp. 171-200.

## 2.1 What type of information?

The objective of obtaining information is to enable the tax administration to determine whether a non-resident taxpayer is carrying on business activities, meets the threshold for taxation, has revenues and expenses connected to the PE and whether the prices charged for dealings between the PE and the non-resident enterprise reflect the arm's length principle. Arguably, the utility of information is more important than the comprehensiveness and quantity of information.

The specific information requirements of the source country may depend on business-specific factors (such as, for instance, in the case of offshore oil and gas projects, insurance, or technical services) or general legal requirements (such as, for instance, in cases where all branches must register irrespective of the nature of business activities). If the source country is concerned with the determination of the PE threshold, since it differs for different types of business activities, it may demand different information for different thresholds. For instance, the ownership of certain categories of property in the source country (for example, factories, natural resources and assets that may constitute an office), contracts with local agents, or contracts with local customers (such as general contractors with sub-contractors). It is not uncommon for countries to require non-resident taxpayers to provide organizational diagrams and information that will permit an assessment of arm's-length prices for related party transactions.

Several considerations need to be taken into account in designing rules on requesting information. First, both taxpayer compliance and the resources of the tax administration should be kept in mind. Non-resident taxpayers will complain about the burden of compliance if they are required to produce and retain information that is perceived to be redundant or cannot be used by the tax administration. In many countries, such information needs to be translated into the official language(s) of the source country, which is another cost of doing business. A "fishing expedition" type of information requirement may backfire on the source country: the information may not be relevant, bad information may crowd out the good, and taxpayers may become "unhappy". As a result, the source country cannot benefit from "information gluttony".<sup>7</sup>

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<sup>7</sup>Ibid.

Second, the format of information is as important as the content. Ideally, tax information should be in electronic format that can be used by the tax administration to make comparisons with other years, other taxpayers and other sectors, or to determine the impact of different cost allocations or transfer pricing models that influence the profit attributable to a PE. Standardization of the data sets and format are important in the “high-tech” details as well as the “low-tech” equivalents (standard paper size and colour coding).

## **2.2 Sources of information**

The main sources of tax information are the non-resident taxpayers, withholding agents, the competent authority of the other treaty country, and other agencies in the source country. Although the requirements applicable to resident taxpayers should apply equally to non-resident taxpayers liable to tax in the source country, the local regime may be inadequate because of the different information required for assessing the tax liability of non-resident taxpayers and the difficulty in obtaining information from non-residents.

### **2.2.1 Taxpayers**

Taxpayers possess the necessary information about their business activities that is relevant for tax purposes. The laws of the source country generally require non-resident taxpayers to provide information in several ways, ranging from tax registration to transactions reporting, tax returns, applications for treaty exemptions, and providing other information based on request.

Tax registration seems to be common in many parts of the world. Under such a system, a non-resident taxpayer is required to register with the tax administration if certain conditions are met, such as carrying on a business activity for a specified period of time (for example, Russia), or establishing a branch or representative office (for example, China<sup>8</sup> and Thailand). For instance, a foreign company

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<sup>8</sup>In China, a foreign company must obtain a business licence for its representative office in China pursuant to the “Regulations on Administration of Registration of Resident Offices of Foreign Enterprises”, issued by the State Council on November 19, 2010. The English text is available at

carrying on business in Thailand, whether setting up a branch or an office, must apply for a tax identification number from the Revenue Department. The taxpayer must complete an application form<sup>9</sup> and provide some supporting documents, such as a copy of a company's registration license. The application form typically asks for information such as the name, address, local agent or representative, type and duration of the business. The registration requirement is not formally connected to the subsequent tax status of the non-resident taxpayer. The tax threshold is determined based on the facts, not merely on the registration. In practice, however, the tax registration may be a strong indication of a significant business presence in the source country.

Transaction reporting provides additional evidence that may be relevant to the taxation of non-resident taxpayers on their business profits in the source country. One type of transaction reporting relates to transactions between related enterprises, which is often part of transfer pricing documentation. The report may cover the relationships, the organizational structure of the enterprise group, the type of transactions, etc. Another common type of transaction reporting relates to services rendered by non-residents. Such reporting is often coupled with a tax withholding requirement.

Tax returns are required to be filed by non-resident taxpayers, in certain circumstances, in accordance with domestic tax law. The return is often the same for domestic and foreign enterprises and is

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<http://english.mofcom.gov.cn/aarticle/policyrelease/announcement/201012/20101207344274.html> (visited on 30 April 2013). Pursuant to the State Administration of Taxation Interim Provisions on the Administration of Taxation of Resident Representative Offices of Foreign Enterprises (Guo Shui Fa [2010] No.18, issued on February 20, 2010, the representative office must register within 30 days of the issuance of the registration certificate with the competent local Tax Bureau. The following documents must be submitted: (i) registration certificate; (ii) approval letter; (iii) evidence of bank account (account book); (iv) Certificate of Enterprise Organization Code; and (v) ID of the individual filing the application. The competent local Tax Bureau will issue (i) a local Tax Registration Certificate and (ii) a State Tax Registration Certificate.

<sup>9</sup>See Thailand, Revenue Department, Income Tax Guide for Foreign Company, at <http://www.rd.go.th/publish/20470.0.html> (visited on 30 April 2013).

filed annually. Non-resident taxpayers must also apply for treaty benefits, often in a prescribed manner.<sup>10</sup> The issue of “double thresholds” is worth mentioning. The threshold for taxing non-resident taxpayers is often lower under domestic law than the PE test. This means that a non-resident taxpayer that meets the domestic threshold may be exempt from taxation if the business activity falls below the PE threshold. Nevertheless, the obligation to file a tax return is based on the domestic threshold. A non-resident taxpayer should disclose its treaty-based return position by declaring that its business activities are insufficient to meet the threshold for taxation in the source country under the applicable treaty. This information may be valuable as it permits the tax administration to examine the validity of the claim of treaty benefit and flags potential targets for audit.<sup>11</sup>

### 2.2.2 Withholding agents

Withholding is particularly effective as a means of collecting income tax on many forms of business profits paid to non-residents (that is to say, dividends, interest, royalties and service fees). It is also an effective and, arguably, the only practical, mechanism for gathering information from non-resident taxpayers who do not have a business presence in the source country. This is true whether or not the withholding tax is final or provisional.

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<sup>10</sup>See, for example, Canada Revenue Agency, Schedule 91, Information Concerning Claims for Treaty-Based Exemptions, available at <http://www.cra-arc.gc.ca/E/pbg/tf/t2sch91/README.html> (visited on 30 April 2013) and China, State Administration of Taxation, Administrative Measures for Non-tax Residents to Enjoy Treaty Benefits (Trial) (the Measures), Guo Shui Fa [2009] No. 124, August 24, 2009, available at [www.chinatax.gov.cn](http://www.chinatax.gov.cn) (in Chinese) (visited on 30 April 2013). A non-resident must submit the following supporting documents to the tax authorities to obtain a treaty-based tax reduction or exemption: (i) application forms; (ii) a resident certificate issued by the competent authority of the treaty country or region; (iii) documents that evidence the taxpayer's right to the payment, such as property ownership certificate, agreement, payment voucher, or certificate issued by an intermediary or notary agent.

<sup>11</sup>See Robert Couzin, “Imposing and Collecting Tax” in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties*, supra footnote 6, at p. 183.

Withholding agents often claim a deduction for the payments (other than dividends) in computing their own tax liability. Therefore, in addition to information returns filed by withholding agents regarding the payments to non-residents, the general corporate tax returns of withholding agents may reveal useful information about payments to non-residents in the form of interest and royalties which are deducted in computing the agent's profits.

### 2.2.3 Other government agencies

Other government agencies that administer corporation registration, intellectual property registration, industry regulation, foreign investment, customs and immigration, often have information relevant to the taxation of business profits earned by non-resident taxpayers. For example, in order to carry on business in Canada, a foreign corporation will need to register as an "extra-provincial corporation" in all the provinces in which it intends to do business.<sup>12</sup> In completing the registration process, the foreign corporation is required to designate an attorney resident in the province who can accept service of legal documents on behalf of the foreign corporation, and a "head office" of the corporation in the province through which business may or may not be conducted. Registration as an extra-provincial corporation does not, in and of itself, amount to a PE for income tax purposes. Similarly, in Australia, a foreign company must register with the Australian Securities and Investments Commission (ASIC).<sup>13</sup> It must file appropriate documentation, appoint a local agent and maintain a registered office and, in certain instances, a register of local members in Australia. Once the foreign company has been registered with ASIC, it must comply with various obligations, such as reporting its financial results to ASIC. Failure to register a foreign company in Australia is a

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<sup>12</sup>See, for example, Ontario, Application for Extra-Provincial Licence Form 1 Extra-Provincial Corporations Act, available at <http://www.forms.ssb.gov.on.ca/mbs/ssb/forms/ssbforms.nsf/FormDetail?openform&ENV=WWE&NO=007-07065> (visited on 30 April 2013).

<sup>13</sup>Australian Securities and Investments Commission, Application for Registration as a Foreign Company, available at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/402.pdf/\\$file/402.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/402.pdf/$file/402.pdf) (visited on 30 April 2013).

strict liability offence and could result in fines by ASIC and the courts. There may be a registration requirement for certain industries, such as banking, insurance, mining, etc.

#### **2.2.4 Exchange of information**

The exchange of information (EOI) mechanism in tax treaties is useful to a source country in obtaining information about a non-resident from the non-resident's residence country.<sup>14</sup> The term "exchange of information" has a very broad meaning. It includes "an exchange of documents and an exchange of information unrelated to specific taxpayers and the provision of information by one contracting State whether or not information is also being provided at that time by the other contracting State."<sup>15</sup> The obligation to provide requested information is for an "effective" exchange of information, meaning that the requested State may not avoid its obligations under Article 26 through unreasonable time delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange.<sup>16</sup> The types of requested information are also broad. For example, in computing the taxable profits of a PE that is located in the source country and has its head office in the residence country, the source country may request information from the residence country about the expenses and profits of the head office and the dealings of the head office with other PEs and associated enterprises.<sup>17</sup>

Developing countries may not be reaping the full benefits of the exchange of information mechanism for several reasons. For example, the source country may not have sufficient information to know the right questions to ask the other country. It may not know if a non-resident enterprise is carrying on business in its country. In the case of

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<sup>14</sup>Generally, see chapter IX, Exchange of information, by Diane M. Ring.

<sup>15</sup>Paragraph 5 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>16</sup>Paragraph 9 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>17</sup>Paragraph 10.1 of the Commentary on Article 26 of the United Nations Model Convention.

automatic or spontaneous exchanges, the exchanged information may not be very useful in the absence of an integrated information system that can accommodate the volume of input and produce useful output. The level of information technology may vary greatly from country to country.

### **3. Identifying the non-resident taxpayer**

#### **3.1 Steps in applying treaty provisions**

There are two important steps in applying treaty provisions. The first step is to identify the person who earns income in the source country and to determine where this person is resident for treaty purposes. The second step is to determine which treaty article might be applicable. This step is important because, as described below, several articles of a treaty may apply to the taxation of business profits.

#### **3.2 Identifying the taxpayer**

A non-resident carrying on business in the source country may be an individual or a corporation. A corporation may be a private company which employs its main shareholder to provide services to its clients. For example, Ms. X, an information technology consultant resident in Country R, may provide her services in Country S as an independent contractor or through Xco, a company established in Country R. In the former case, Ms. X is the taxpayer in respect of the profits arising from the services rendered. In the latter case, Xco is the taxpayer in respect of the profits from the services provided by Ms. X; Ms. X does not earn any business profits, but employment income from Xco.

A non-resident corporation may also be a multinational enterprise (MNE) making investments in the source country. Such a corporation may carry on business activities in the source country directly through a PE or a subsidiary company established in the source country. Because a subsidiary company is a separate entity from its parent, any business profits earned by the subsidiary are taxable only to the subsidiary, not the parent. The parent company may be taxable in the source country only on the dividends from the subsidiary. In contrast, if a MNE carries on business in the source country through a PE, the

MNE is the taxpayer with respect to the business profits earned in the source country. As mentioned below, however, if the subsidiary acts as a dependent agent of its parent or the parent uses the premises of a subsidiary to carry on its own business in the source country, the parent may be considered to have a PE and be liable to tax in the source country on the profits attributable to it.

### **3.3 Determining the resident status of the taxpayer**

The question of where a taxpayer is resident for treaty purposes is important in applying treaty provisions. Because the meaning of “residence” is governed primarily by domestic law, a taxpayer may be considered a resident in both treaty countries pursuant to their respective domestic laws. In such a case, it is important to apply the treaty tie-breaker rules to determine the taxpayer’s residence for treaty purposes.

The issue of dual residence of individuals often arises where the individual maintains a permanent home and personal and social ties in one country and spends a significant amount of time in another country. Under the domestic laws of the visiting (source) country, he is considered a resident on the basis of the length of stay in that country (typically 183 days). Under the domestic laws of the home (residence) country, he is considered a resident on the basis of the permanent home and/or personal and social ties. The issue of dual residence of corporations arises where a corporation is incorporated under the laws of one country, but has its place of central/effective management in another country.

The tie-breaker rules in Article 4 of both the United Nations and OECD Model Conventions resolve the problem of dual residence of individuals by reference to the location of a permanent home, centre of vital interests (personal and economic) or habitual abode. If these rules fail to break the tie, the competent tax authorities are required to resolve the problem by reaching a mutual agreement according to the procedure established in Article 25. The place of effective management is the tiebreaker for corporations.

Having access to relevant information is obviously critical to the tax authorities. In general, the taxpayer is the primary source of information and is motivated to provide enough information to break the tie.

### 3.4 Determining which treaty provision(s) might apply

Once it is determined that a taxpayer is a non-resident carrying on business activities in the source country, the next step is to determine which of the treaty provisions might apply to the taxation of profits arising from such activities. As explained below, business profits may be taxable under several articles of a tax treaty.

## 4. Treaty framework for taxing business profits

### 4.1 “Business” and “profits”

The terms “business” and “profits” are normally not defined in tax treaties.<sup>18</sup> Pursuant to Article 3 (2), undefined terms used in a treaty generally have their meanings in the domestic law of the country applying the treaty. In general, civil law countries tend to characterize all of the income of business enterprises as “business” income. Common law countries tend to distinguish between business income and passive investment-type income.<sup>19</sup> “Profits” generally means net profit under the domestic income tax laws. Cost and expenses incurred for business purposes are generally deductible in computing profit.

The types of business are arguably unlimited as new forms of business constantly emerge and existing businesses undergo transformation. Generally speaking, all business activities involve capital and human efforts. The United Nations Model Convention recognizes the following forms of businesses:

- Manufacturing and processing (factory, workshop) (Article 5 (2))
- Sales and trading (office, branch) (Article 5 (2))

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<sup>18</sup>Under the OECD Model Convention, Articles 5 and 7 apply to professional and other independent services, whereas the United Nations Model Convention has a separate provision, Article 14, for the taxation of such services.

<sup>19</sup>See John F. Avery Jones, et al., “Treaty Conflicts in Categorizing Income as Business Profits: Differences in Approach Between Common Law and Civil Law Countries”, in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties*, supra footnote 6, at pp. 25-54.

- Extraction of natural resources (Article 5 (2))
- Construction (Article 5 (3) (a))
- Services (including consultancy services) (Article 5 (3) (b) and Article 14)
- Insurance (Article 5 (6))
- Professional services (Article 14)
- Agriculture and forestry (Article 6)
- Immovable property (Article 6)
- Banking (Article 7 (3))
- Transport (Article 8)
- Investment (Articles 10, 11 and 12) (that is to say, investment in equity, lending, licensing and leasing).

## 4.2 Taxation of business profits under various articles

Business profits derived by non-residents in the source country are potentially taxable under several provisions of a tax treaty, depending on the type of business activity. For example, profits from immovable property are taxable under Article 6; profits from international shipping and transportation are taxable under Article 8; profits from holding investments or licensing or leasing property are taxable under Articles 10, 11 and 12; and profits from services may be taxable under Article 14 (United Nations Model Convention, independent personal services) and Article 17 (artistes and sportspersons). These other provisions prevail over Article 7, subject to the throwback rules in Article 10 (4), Article 11 (4) and Article 12 (4) of the United Nations Model Convention and Article 12 (3) of the OECD Model Convention. Each provision contains its own threshold for source country taxation.

For example, in the case of Ms. X carrying on business as an independent contractor, her profits would be taxable under Article 14 of the United Nations Model Convention, whereas the income earned by Xco would be taxable under Article 7. The MNE that carries on business in the source country through a PE would be taxable under Article 7, but under Article 10 if it carries on business in the source country through a local subsidiary when the subsidiary distributes the profits in the form of dividends.

### 4.3 Threshold for source taxation

Business profits are taxable in the source country when the threshold for taxation is satisfied. As summarized in the following table, the United Nations Model Convention specifies different thresholds for some types of business.

**Table: Taxation of business profits under the United Nations Model Convention**

<i>Type of business profits</i>	<i>Article</i>	<i>Threshold for taxation in source country</i>	<i>Taxable amount</i>
General	7	PE	Net profit
Immovable property	6	Situs of property	Net profit (gross-basis withholding on rent is allowed in some cases)
Transport	8	N/A (exclusive taxation in the residence county)	
Dividends, interest, and royalties	10, 11 and 12	Residency of payer, or PE or fixed base that bears the cost of the interest/royalties	Gross amount under Articles 10, 11 and 12 Net basis under Articles 7 and 14
Alienation of movable property forming part of a PE or fixed base	13	PE or fixed base	Net basis
Alienation of immovable property	13	Situs of the property	Net basis
Alienation of shares of a company if the property of the company consists “principally” (> 50%) of immovable property	13	Situs of the property	Net basis
Alienation of ships, boats and aircrafts	13	Place of effective management of the enterprise	Net basis

<i>Type of business profits</i>	<i>Article</i>	<i>Threshold for taxation in source country</i>	<i>Taxable amount</i>
Independent personal services	14	Fixed base, or Physical presence of 183 days or more	Net basis
Artistes and sportspersons	17	Place of activities/ performance	Net basis (generally)

#### **4.4 Electronic commerce and business activities carried out in the absence of a PE/fixed base**

The existing treaty framework for taxing business profits relies on the existence of a PE or fixed base, as well as the physical presence of the non-resident taxpayer in the source country. It is somehow inadequate for dealing with electronic commerce and other new business models that require no PE/fixed base or physical presence in the source country while capable of generating large amounts of profits from transactions with customers located in the source country. One example is online sales of goods (tangible and digital products) that can be delivered through traditional means (such as postal or courier services) or downloaded from a website. Another example is the provision of a variety of services, including information technology, some professional services, financial services, back-office support, training, and call-centres. E-commerce transactions may take place between a business and consumers or between businesses.

The country where the customers are located has no jurisdiction to tax the business profits under the treaty for lack of a PE or fixed base in that country. However, it is possible for the source country to characterize the transactions as giving rise to a royalty, as opposed to business profits, so that Article 12 may apply. In some tax treaties concluded by developing countries, technical fees are treated like royalties and are subject to a final withholding tax in the source country even when the technical services are provided outside the source country, as long as the payer is a resident of the source country. The taxation of remote business activities in this case is administratively feasible because the amount of payments tends to be significant and bundled

with royalties in technology transfer agreements. Since royalties are subject to withholding tax, there is little additional compliance burden on the withholding agent in respect of withholding from technical fees. This is particularly true in the case of business-to-business transactions. Business-to-consumer transactions are more problematic as it is unrealistic to expect consumers to withhold tax from each small amount of payment to non-resident vendors or service providers.

In order to enable the tax authority of the source country to apply Article 12, domestic tax laws need to clearly permit an expansive definition of royalty and that Article must follow the United Nations Model Convention.

#### **4.5 Non-discrimination**

According to Article 24 (3) of both the United Nations and OECD Model Conventions, the source country is prohibited from discriminating against PEs of non-resident enterprises. That Article states that the taxation of a PE shall not be less favorably levied in the source country than the taxation levied on enterprises of that State carrying on the same activities. Similar businesses conducted by local residents and non-residents should, therefore, be treated similarly. This is likely one of the reasons why Article 7 prescribes only general principles for the determination of the amount of profit taxable in the source country. The general rules of accounting and source rules under domestic law generally apply to attributing profits to a PE. Similarly, the general rules of tax reporting and payments are presumably the same or similar for domestic enterprises and non-resident taxpayers.

Specific rules or administrative practices that seek to determine the profits attributable to a PE, even if they are different from those applicable to branches of domestic companies, are generally not discriminatory within the meaning of Article 24 (3) of the United Nations Model Convention. The key test is whether the differential treatment results in more burdensome taxation for the PE.

## 5. Permanent establishment

### 5.1 General threshold and the “effectively connected” rule

Article 7 (1) of both the United Nations and OECD Model Conventions provides that the business profits of an enterprise resident in one country cannot be taxed in the other country unless the business is carried on through a PE in that other country (or source country). The existence of a PE is thus a threshold for taxation by the source country. Furthermore, once a non-resident taxpayer has a PE in the source country, not only business profits attributable to the PE are taxable in the source country, but so are dividends, interest and royalties if the holding of the shares, debts or property is effectively connected with such PE.<sup>20</sup> The United Nations Model Convention further allows the source country to tax profits derived from sales in the source country of goods and merchandise of the same or similar kind as those sold through that PE, or other business activities carried on in the source country of the same or similar kind as those effected through that PE. Tax treaties define the meaning of a PE in different ways, depending on the type of activities.<sup>21</sup>

Access to reliable information is critical to the determination of whether a PE or fixed base exists. Useful sources of information include local business registration offices, regulatory approval agencies (as in the case of insurance, professional regulation, banking and financial services, etc.), local agencies that issue building permits, and resident corporations that make payments to non-resident taxpayers or receive payments from non-resident taxpayers (as in the case of sub-contractors). Where the length of physical presence of individuals is relevant, the dates of entry and/or exit stamped in the passport may be a source of evidence.

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<sup>20</sup>Article 10 (4), Article 11 (4) and Article 12 (4), respectively, of the United Nations Model Convention.

<sup>21</sup>For further discussion, see Brian J. Arnold, “Threshold Requirements for Taxing Business Profits under Tax Treaties,” in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties*, supra footnote 6, at p. 55-108.

## 5.2 Fixed place of business without specific time requirement

Article 5 (1) of both the United Nations and OECD Model Conventions defines the term permanent establishment to mean “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. A fixed place of business is thus clearly the core of the concept of PE. It generally refers to a specific geographical location that is used to carry on business. Each geographical location is treated separately unless the places constitute a “coherent whole commercially and geographically”.<sup>22</sup> The place of business must have a “certain degree of permanency, that is to say, if it is not of a purely temporary nature”.<sup>23</sup>

Article 5 (2) lists the following examples of fixed places of business: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

## 5.3 Building site, project or supervisory activity lasting more than six months

The nature of a construction business is service. When a non-resident corporation builds buildings, roads, bridges or canals or lays pipe-lines, etc., the non-resident taxpayer is rendering a service to its clients who own the building, road, etc. Article 5 (3) of the United Nations Model Convention provides that a PE encompasses a building site, a construction, assembly or installation project or supervisory activities in connection therewith,<sup>24</sup> but only if such site, project or activities last more than six months (twelve months under the OECD Model Convention).

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<sup>22</sup>Paragraph 3 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 5.1 of the Commentary on Article 5 of the OECD Model Convention.

<sup>23</sup>Paragraph 3 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 5 of the OECD Model Convention.

<sup>24</sup>The OECD Model Convention does not mention assembly and supervisory activities. For further discussion of the differences between the United Nations and OECD Model Conventions, see paragraph 7 of the Commentary on Article 5 of the United Nations Model Convention.

In determining how long the site, project or activity has existed, no account is taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. In other words, a non-resident taxpayer may spend five months on each unconnected building site without having a PE.<sup>25</sup> On the other hand, the very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously (for example, building roads or canals) as the project progresses. In this case, the activities performed at each spot are treated as part of a single project and the project is regarded as a PE if, as a whole, it lasts for more than six months.<sup>26</sup>

#### **5.4 Physical presence for more than 183 days**

The United Nations Model Convention uses a physical presence threshold for professional services (Article 14) and other services (Article 5 (3) (b)). For example, Article 5 (3) (b) provides that a PE encompasses “the furnishing of services, including consultancy services, by an enterprise, but only if activities of that nature continue (for the same or a connected project) within a contracting State for a period or periods aggregating more than 183 days in any 12-month period”. A similar physical presence test applies to independent personal services under Article 14 of the United Nations Model Convention.<sup>27</sup>

In the case of entertainers and sportspersons, however, there is no specific time requirement (Article 17). Therefore, any performance of entertainment or athletic activities in the source country is sufficient to give the source country the right to tax.

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<sup>25</sup>Paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 18 of the Commentary on Article 5 of the OECD Model Convention.

<sup>26</sup>Paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 20 of the Commentary on Article 5 of the OECD Model Convention.

<sup>27</sup>For further discussion of Article 14, see chapter VI, Taxation of non-resident service providers, by Ariane Pickering.

## 5.5 Collection of insurance premiums or insurance of risks

Article 5 (6) of the United Nations Model Convention deems a non-resident enterprise to have a PE if it collects insurance premiums in the source country or insures risks situated in the source country through a person other than an independent agent. The activity of collecting premiums or the location of the risks alone gives rise to a PE. There is no requirement of a fixed place of business or any time requirement.

This deeming rule and Article 17 are the most significant deviations from the core notion of PE as they require neither “a place of business” nor “any degree of permanence” in the source country.

## 5.6 The nature and level of activity of agents

Instead of carrying on business in the source country directly, a non-resident enterprise may carry on business activities through an agent. Article 5 (5) of the United Nations Model Convention provides that a dependent agent constitutes a PE if the agent has the authority to conclude contracts on behalf of the non-resident enterprise and habitually exercises that authority in the source country,<sup>28</sup> or if the agent has no authority to conclude contracts, but habitually maintains in the source country a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident enterprise.<sup>29</sup> Merely having employees or agents present in the source country does not give rise to a PE.

The activities of an independent agent do not constitute a PE. However, the independent status is not available when the activities of an agent are carried out wholly or almost wholly on behalf of the non-resident enterprise, and there is no arm’s length relationship between the agent and the non-resident enterprise.<sup>30</sup>

In general, even if a non-resident enterprise has a fixed place of business or dependent agents in the source country, no PE exists if the business activities are of “preparatory or auxiliary nature” (Article 5 (4)).

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<sup>28</sup>Article 5 (5) (a) of the United Nations Model Convention.

<sup>29</sup>Article 5 (5) (b) of the United Nations Model Convention.

<sup>30</sup>Article 5 (7) of the United Nations Model Convention.

## 5.7 Subsidiary versus PE

Very often business activities in the source country can be carried on by a non-resident enterprise through a local company or a PE. A subsidiary company is a separate entity and taxable on its income. Technically, the source country is the residence country of the subsidiary. Economically speaking, however, the subsidiary's income may be derived exclusively from business activities in the source country in the same way as a PE.

Article 5 (8) of the United Nations Model Convention is clear that a subsidiary company should not of itself constitute a PE of the parent. However, if the subsidiary acts as an agent on the parent's behalf, or the parent uses the subsidiary's place of business to conduct its own business activities, the subsidiary may be deemed to be a PE of the parent. In such cases, the subsidiary's income and the parent's income must be separated for source country tax purposes. The non-resident parent is taxable in the source country on business profits attributable to the PE. The subsidiary is taxable on its income.

Transfer pricing issues must be considered in examining the transactions between the subsidiary and the parent, irrespective of the status of the subsidiary as a separate company or a PE.

In order to enable the tax authority of the source country to assess a non-resident company in respect of business profits derived from the activities carried out through its subsidiary, the domestic tax laws of the source country should allow the tax authority to characterize relationships between the parent and its subsidiary on the basis of business substance as opposed to legal formalities. For example, the subsidiary may be considered a dependent agent of the parent even though it does not formally have the authority to conclude contracts on behalf of the parent.<sup>31</sup>

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<sup>31</sup>Both the OECD Commentary on Article 5 (paragraph 32.1) and the United Nations Commentary on Article 5 (paragraph 23) permit such characterization under certain circumstances.

## **6. Attribution of profits**

### **6.1 Introduction**

Once a PE exists in the source country, Article 7 allows the source country to tax the profits attributable to the PE as long as these profits are not taxable under other provisions of the treaty. The determination of the amount of profits attributable to the PE is governed by Article 7 as well as domestic law. The main issues in applying Article 7 include the scope of the force of attraction doctrine, transfer pricing issues, deductibility of expenses and source rules. A related issue is the relationship between Article 7 and the non-discrimination provision in Article 24. There are also administrative issues related to trading accounts, books and records and burden of proof.

### **6.2 Force of attraction**

A general principle in Article 7 is that the source country's right to tax the non-resident enterprise's business profits does not extend to profits which are derived by the enterprise from that country but that are not attributable to the PE. This means that the tax authorities of the source country should look at the separate sources of profits that the enterprise derives from its country and apply to each the PE test. For example, an enterprise may set up a PE in the source country to carry on manufacturing or processing activities and also sells different products in the source country through an independent agent. Only the profits of the PE are taxable in the source country. As such, Article 7 rejects the "force of attraction" principle, which would allow the source country to tax not only the profits attributable to the PE, but also other profits (such as the sales of different products through an independent agent), dividends, interest and royalties arising from sources in the source country.

The United Nations Model Convention adopts a limited force of attraction rule which allows the source country to tax profits attributable to sales in the source country of goods or merchandise of the same or similar kind as those sold through the PE or other business activities carried on in the source country of the same or similar kind as those effected through the PE. This functions as a limited anti-avoidance rule.

Owing to the lack of information, it is not easy for the source country to assess a non-resident taxpayer on income that is effectively connected with a local PE. For example, a MNE resident in Country R that carries on the business of equipment leasing in Country S through a PE in Country S also rents equipment to customers in Country X. If the key employee who works at the PE in Country S plays a key role in negotiating contracts with the customers in Country X, the rental income may be effectively connected to the PE. However, the customers in Country X have no legal obligation to provide information to the tax authority in Country S. The MNE may decide that the rental payments are not attributable to the PE in Country S and not report it in its tax return. Unless Country S obtains information from the competent tax authority in Country R, there may not be any information on the rental income arising in Country X.

### **6.3 Transfer pricing issues**

The profits of the PE are to be determined as if it were a distinct and separate enterprise dealing at arm's length with the non-resident enterprise and other parts of the enterprise. If the enterprise has multiple PEs, the income attributable to each PE must be determined separately. If domestic enterprises are not required to compute the income of each branch separately, a potential tax discrimination issue arises under Article 24.

It is beyond the scope of this chapter to discuss the transfer pricing rules. It suffices to note that there are additional challenges in applying the transfer pricing rules to the PE. For example, the “transactions” between the PE and the enterprise are based on internal agreements, not legally binding contracts. Some enterprises may not keep separate or accurate accounts for each PE. If available accounts do not represent the “real” facts, then “new accounts will have to be constructed, or the original ones rewritten and for this purpose the figures to be used will be those prevailing in the open market.”<sup>32</sup>

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<sup>32</sup>Paragraph 15 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 14 of the Commentary on Article 7 of the 2005 OECD Model Convention.

## 6.4 Deductibility of expenses

The deductibility of expenses is generally governed by domestic law. Expenses incurred for the purpose of earning business income are generally deductible. The amount of deduction may be limited to the reasonable amount.<sup>33</sup>

Only actual expenses incurred for the purposes of the business of the PE are deductible. Payments of royalties, fees for services and interest (other than a banking enterprise) between the PE and the non-resident enterprise are not recognized under Article 7 (3) of the United Nations Model Convention. The ban does not apply to interest, royalties and fees actually incurred and paid to third parties. In the case of internal debts (other than in the case of banks), because money is fungible, it may be difficult to determine the portion of interest payable on internal loans and the portion on loans from third parties. The Commentary on Article 7 of the United Nations Model Convention suggests a practical solution: the determination “would take into account a capital structure appropriate to both the organization and the functions performed taking into account the need to recognize that a distinct, separate and independent enterprise should be expected to have adequate funding”.<sup>34</sup>

To take advantage of the rules in Article 7 (3), the source country’s domestic tax laws may need to provide similar rules. An example can be found in Article 49 of the Chinese Enterprise Income Tax Regulations, which states: “In computing income, no deduction is allowed for management fees paid between enterprises, rents and royalties paid between branches (or business establishments) of the same enterprise, and interest payments between branches (or business establishments) of the same enterprise that is not a bank.”<sup>35</sup>

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<sup>33</sup>For example, section 67 of the Canadian Income Tax Act limits the amount of deductible expense to the reasonable amount.

<sup>34</sup>Paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention.

<sup>35</sup>The text of this statute is available at the State Administration of Taxation’s website, [www.chinatax.gov.cn](http://www.chinatax.gov.cn). For an unofficial English translation, see [http://www.deloitte.com/view/en\\_CN/cn/services/tax/dtrf/b45b08d8fc412210VgnVCM200000bb42f00aRCRD.htm](http://www.deloitte.com/view/en_CN/cn/services/tax/dtrf/b45b08d8fc412210VgnVCM200000bb42f00aRCRD.htm); [www.kpmg.com.hk/en/virtual\\_library/Tax/PRCtaxLawBook.pdf](http://www.kpmg.com.hk/en/virtual_library/Tax/PRCtaxLawBook.pdf).

## 6.5 Source rules

In applying Article 7, a question of geographical source may arise. Does the phrase “profits attributable to a PE” mean profits resulting from transactions and activities in the PE country or profits from transactions and activities connected with the PE, irrespective of whether they are located in the PE country or not? The latter meaning is considered more appropriate.<sup>36</sup> In attributing profits to a PE, it is the nexus of a revenue or expense with the business activity of the PE that is important, not necessarily the geographical source of the revenue or expense in the source country. The key is whether the revenue or expense is related to the activities carried on by the PE in earning the income that is considered taxable in the source country.

The above point is confirmed by the effectively connected principle underlying Articles 10, 11 and 12: dividends, interest, royalties and other income that is effectively connected with a PE are attributable to the PE and taxable under Article 7. However, the force of attraction rules under Article 7 (1) (b) (c) capture only the profits from sales and other business activities carried on in the source country.

## 6.6 Trading accounts, books and records and apportionment

The computation of profits attributable to a PE often starts with the “real facts of the situation as they appear from the business records of the PE and to adjust as may be shown to be necessary the profit figures which those facts produce”.<sup>37</sup> The business records may include trading accounts of the PE or even separate accounts of the PE. The accounts may need to be rectified by the tax authorities in accordance with the arm’s length principle discussed above.

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<sup>36</sup>Brian J. Arnold and Jacques Sasseville, “Source Rules for Taxing Business Profits under Tax Treaties,” in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties*, supra footnote 6, at pp. 117-124.

<sup>37</sup>Paragraph 15 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 12 of the Commentary on Article 7 of the OECD Model Convention.

Apportioning of the non-resident enterprise's profits to the PE on the basis of some formulae is allowed as long as it has been customary in the source country to use this method and the result is in accordance with the principles of Article 7. The method of attributing profits to a PE should be the same year by year unless there is good and sufficient reason to the contrary.

The requirement of documentation and record keeping may be supported by the power of the tax administration to assess the amount of profits attributable to a PE by using a deemed method. The basis of the deemed method can be gross sales, cost, or average profit level of similar businesses in the region.

## **6.7 Time limits and burden of proof**

Article 7 does not deal with time limits or the burden of proof. These issues are governed by domestic law. In countries that implement a self-assessment system, non-resident enterprises are normally required to file annual tax returns in the same manner as residents in the source country. In the case of disputes, generally the taxpayer bears the burden of proof of facts.

## **7. Tax collection and enforcement**

Enforcement of tax liabilities of non-resident taxpayers generally depends on the physical presence of a PE, assets within the source country and withholding. One of the reasons for using the PE threshold in tax treaties is the practical difficulty in tax collection without it. If a non-resident taxpayer has a factory, a mine or other fixed places of business in the source country, it is generally easier for the tax authorities to seize the assets attached to the PE. If the value of those assets is sufficient to satisfy the tax claim, enforcement is not a problem. Even if the assets are not attached to a PE but are located within the source country, they may be subject to domestic collection measures.

Difficulties arise when the taxpayer's assets are located abroad. In the absence of a tax treaty, the source country's tax claims are generally not recognized or enforced in foreign countries on the ground

of the “revenue rule” in international law.<sup>38</sup> This rule is overruled by Article 27 of both the United Nations and OECD Model Conventions, which provides for mutual assistance in tax collection. It is unclear how many developing countries actually include this provision in their tax treaties and if this provision has been used in practice.

## 8. Conclusions

Effective taxation of non-residents’ business profits by the source country requires thoughtful provisions in domestic law and tax treaties that define and measure the non-residents’ tax liability as well as an efficient and workable system of reporting, verification and collection.

Through strengthening the capacity to administer the taxation of non-residents on business profits, the tax authorities in developing countries may be able to adopt some good practices in other countries or international norms and use them as a catalyst to improve tax administration in general. It is true that the administration of domestic taxation is different from the administration of international taxation. But, the procedures and measures put in place to effectively collect taxes from non-residents may be used to collect taxes from domestic enterprises. This is particularly true in countries that are at the early stage of developing capacity in administering income taxation.

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<sup>38</sup>More discussion of the revenue rule can be found in Maria Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims* (The Hague: Kluwer Law International, 2003), at pp. 16-40.



## Chapter VI

### Taxation of non-resident service providers

ARIANE PICKERING\*

#### 1. Introduction

Tax treaties provide for a range of different tax treatments of income derived by non-resident service providers, depending on the category of services giving rise to the income.

Since the tax treatment permitted under the treaty can range from exemption from source taxation to exclusive source taxation, from limited to unlimited rates of source taxation, and from gross to net taxation, taxation of non-resident service providers can present a number of challenges to tax administrations. In addition to that, there is a wide range of thresholds provided under treaties for source taxation of services income, and, thus, the rules can become extremely complex to administer, particularly for tax administrations in developing countries where both the tax systems and the tax administrations may be less sophisticated and effective than those in developed countries. Availability of personnel skilled in international tax and tax treaty matters may also be a problem for tax administrations in developing countries where scarce resources have to cover a wide range of issues.

The following section of this chapter will look at the ways in which different categories of income derived by non-residents from services are dealt with under tax treaties and the administrative issues that they raise. Then, the present chapter will look at ways in which tax authorities may address these administrative concerns.

#### 2. Source taxation of services income

Income from services furnished by non-resident service providers is dealt with under a number of different articles of a tax treaty. Since

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developing countries generally follow the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>1</sup> (United Nations Model Convention), this chapter will focus primarily on the provisions of that Model Convention. Where relevant, differences found in the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>2</sup> (OECD Model Convention) will also be discussed.

Under the United Nations Model Convention, the following Articles are relevant:

- Articles 5 and 7 — business profits
- Article 8 — international transport income
- Article 14 — income from independent personal services
- Article 15 — employment income
- Article 16 — directors' fees and remuneration of top-level managers
- Article 17 — income of artistes and sportspersons
- Article 19 — remuneration from government services
- Article 20 — payments to students, business trainees and apprentices.

Services are dealt with in the same articles of the OECD Model Convention, other than Article 14, which was deleted in 2000. Independent personal services are now dealt with in the OECD Model Convention under Articles 5 and 7.

Treaties of many developing countries also include other provisions, not found in either Model Convention, which deal with:

- Fees for technical services or assistance; and/or
- Income of teachers and professors.

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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

<sup>2</sup>Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

A few countries consider that Article 12 and/or Article 21, dealing, respectively, with royalties and income not otherwise dealt with under the treaty, are relevant to taxation of income from the provision of services.

Different tax treatment is provided for each of these categories of income.

## **1.1 Article 5 and Article 7 — Business profits**

The general provision that applies to income from services under most tax treaties is Article 7, Business profits. This Article applies unless the income is dealt with under another article in the treaty.<sup>3</sup>

In accordance with Article 7, profits of an enterprise of one of the treaty partner countries from the provision of services will be taxable only in that country unless the profits are attributable to a permanent establishment situated in the other treaty partner country. The term “permanent establishment” (PE) is defined for treaty purposes in Article 5, Permanent establishment and, in the case of treaties that follow the United Nations Model Convention, generally refers to:

- A fixed place of business through which the business of the enterprise is carried on<sup>4</sup> (fixed place of business PE)
- A building site, a construction, assembly or installation project, or related supervisory activities, that last more than six months;<sup>5</sup> or

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<sup>3</sup>Article 7 (6) of the United Nations Model Convention and Article 7 (4) of the OECD Model Convention.

<sup>4</sup>Article 5 (1) and (2) of the United Nations Model Convention.

<sup>5</sup>Article 5 (3) (a) of the United Nations Model Convention. The equivalent provision of the OECD Model Convention, Article 5 (3), has a time threshold of twelve months, and does not refer specifically to assembly projects or supervisory activities. Nevertheless, paragraph 17 of the Commentary on Article 5 of the OECD Model Convention clarifies that supervision of the erection of a building is covered by Article 5 (3). Also, paragraph 20 of the Commentary on Article 5 of the OECD Model Convention provides an example dealing with an assembly project.

- The furnishing of services — for the same or a connected project — within a country for more than 183 days in a twelve-month period<sup>6</sup> (“deemed services PE”).

Where a service provider from one contracting State carries on business through a permanent establishment in the other State, that other State may tax profits of that enterprise, but only to the extent that the profits are attributable to the permanent establishment. Article 7 of the United Nations Model Convention also permits source taxation of profits from other business activities carried on in that State where those activities are of the same or a similar kind to those effected through the permanent establishment (so called “limited force of attraction”).<sup>7</sup> However, this latter provision is not widely adopted in actual treaties.

The administrative requirements for establishing entitlement to exemption, or for taxing profits attributable to a fixed place of business PE, are not substantially different in the case of service provider enterprises to those applicable to other business activities. However, these issues are dealt with in another chapter.<sup>8</sup>

Difficulties faced by tax administrations in applying Articles 5 and 7 to other profits derived by service provider enterprises include:

- Identification of non-resident enterprises carrying on service activities in the country
- Application of time thresholds
- Determination of attributable profits.

In treaties that provide for limited force of attraction, difficulties may also be encountered in identifying service activities being carried on in the country and in determining whether the activities are the same or similar to those effected through a permanent establishment.

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<sup>6</sup>Article 5 (3) (b) of the United Nations Model Convention. Article 5 of the OECD Model Convention does not include an equivalent provision. However, an alternative deemed services PE provision is suggested in paragraph 42.23 of the Commentary on Article 5 of the OECD Model Convention.

<sup>7</sup>There is no equivalent provision in the OECD Model Convention.

<sup>8</sup>See chapter V, Taxation of non-residents on business profits, by Jinyan Li.

## 1.2 Article 8 — International transport

Article 8 of the United Nations Model Convention offers two alternative tax treatments for profits from international transport activities. Alternative A adopts the same approach as the OECD Model Convention in providing that profits from the operation of ships or aircraft in international traffic are taxable only in the country in which the enterprise has its place of effective management. Alternative B provides the same treatment for profits from aircraft operations in international traffic, but provides for limited source taxing rights over profits from shipping activities in the source State that are more than casual. In such case, the source State may tax an “appropriate allocation of the overall net profits” from the shipping operations, with the source tax being reduced by an agreed percentage.

Profits from the operation of boats in inland waterways transport are taxable only in the country in which the enterprise has its place of effective management. Exemption from source taxation applies even if the profits are derived from inland waterways transport between two points in the source country.

Where it provides exemption from source taxation, Article 8 alleviates the compliance and administrative difficulties, as well as the risks of double taxation that would result from source taxation in the many countries where an international transport enterprise operates. As noted in the Commentary on Article 8 of the United Nations Model Convention, even countries that wish to retain source taxing rights over shipping profits recognise that “considerable difficulties were involved in determining a taxable profit in such a situation and allocating the profit to the various countries concerned in the course of the operation of ships in international traffic”.<sup>9</sup>

## 1.3 Article 14 — Independent personal services

The general rule under treaties for independent personal services income derived by non-residents is that such income is exempt from source taxation unless it is either:

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<sup>9</sup>Paragraph 3 of the Commentary on Article 8 of the United Nations Model Convention.

- Attributable to a fixed base of the service provider in the source State; or
- Derived from activities performed in the source State if the service provider is present in that State for at least 183 days in a twelve-month period.

The application of this Article raises a number of issues for tax administrations, including:

- Characterization of income from “professional services or other activities of an independent character”
- Determination of whether the service provider has a fixed base in the source country or has been present, or is intending to be present, in the country for at least 183 days
- Determination of income attributable to a fixed base, or derived from activities performed in the country
- Collection of tax, particularly where it is not known whether the service provider is likely to be present in the country for the requisite number of days.

Under a few treaties, source taxation is also permitted where the income exceeds an agreed monetary threshold.

#### **1.4 Article 15 — Dependent personal services**

The general rule under Article 15 with respect to taxation of employment income (income from dependent personal services) derived by residents of a treaty partner country is that the remuneration may be taxed in the other country only if the employment is exercised in that country.

Notwithstanding this general rule, an exemption from source taxation applies if the following three conditions are met:

- The employee is present in the source country for 183 days or less in any twelve-month period commencing or ending in the fiscal year concerned
- The remuneration is paid by, or on behalf of, a non-resident employer, and

- The remuneration is not borne by a permanent establishment or a fixed base of the non-resident employer, which is situated in the source country.

A special rule applies under Article 15 for remuneration from employment exercised aboard ship or aircraft in international traffic, or a boat engaged in inland waterways transport. Such remuneration may be taxed in the country in which the place of effective management of the transport enterprise is situated (or in the country of residence of the enterprise, where that formulation is used in the treaty).

Administrative issues raised by the application of this article include:

- Identification of employment services exercised in the country
- Determination of who is the 'employer' and whether the employer is a resident
- Determination of the income derived from employment exercised in the country
- Imposition and collection of tax.

### **1.5 Article 16 — Directors and top-level managers**

Article 16 of the United Nations Model Convention allocates taxing rights over fees paid by resident companies to directors or salaries, wages and other remuneration paid to top-level managers in respect of their activities as such. Under this Article, it does not matter whether the activities are performed in the source country or not.

Administrative issues include:

- Identification of directors and high-level managers
- Characterization of income derived in their capacity as director or high level manager
- Imposition and collection of tax.

### **1.6 Article 17 — Artistes and sportspersons**

Tax treaties provide that income of artistes and sportspersons in respect of their activities as such may be taxed in the country where the

activities are exercised. The source country may also tax the income from their activities if it accrues to another person, such as a team, management company or a star-company.<sup>10</sup>

Since the treaty does not limit the source tax that may be imposed, the issues that tax administrations are most likely to encounter will concern claims by taxpayers that their income is not covered by the Article. The main administrative issues faced by tax authorities will be:

- Determination of the character of the income
- Identification of entertainment activities exercised in the jurisdiction
- Imposition and collection of tax.

## **1.7 Article 19 — Government service**

Article 19, Government service, is unique in that it provides for exclusive taxation in the paying State for salaries, wages and other similar remuneration paid in respect of services rendered by an individual to that State. This accords with longstanding rules of international courtesy.

The country of which the individual is a resident may only tax the remuneration if the activities are exercised in that country and the person is either a national of that country or did not become a resident solely for the purpose of rendering the services. In these circumstances, the remuneration may not be taxed in the paying State.

Exemption from taxation in the paying State will depend on a determination that:

- The services are rendered in the other treaty partner country
- The individual is a resident of that other country who is either a national of that other country, or had reasons for becoming a resident other than just to perform the governmental services.

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<sup>10</sup>See paragraphs 11, 11.1 and 11.2 of the Commentary on Article 17 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraphs 11, 11.1 and 11.2 of the Commentary on Article 17 of the OECD Model Convention.

## 1.8 Article 20 — Students

In accordance with Article 20, payments received from abroad by visiting foreign students, business trainees or apprentices for their maintenance, education or training are exempt from tax in the country visited. For purposes of application of this Article, in countries that would otherwise tax such payments, it is necessary to determine:

- Whether the recipient is a student, business trainee or apprentice
- Whether the recipient is visiting the country solely for the purpose of his education or training
- Whether the payments are for the purpose of maintenance, education or training of that person, and
- Whether the source of the payments was abroad.

## 1.9 Other treaty provisions

Many tax treaties, particularly treaties entered into by developing countries, include additional provisions relating to fees for technical services and/or for remuneration of teachers. While these provisions are not currently found in the United Nations Model Convention, the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) is exploring whether additional provisions should be included with respect to fees for technical services<sup>11</sup>. The Commentary on Article 20 of the United Nations Model Convention also discusses a number of issues relating to the possibility of an independent article to deal with visiting teachers.<sup>12</sup>

Although, in the absence of a model provision, current articles dealing with fees for technical services or remuneration of visiting teachers necessarily differ, the discussion below is based on the most common forms of such articles found in existing treaties.

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<sup>11</sup>See paragraph 17 of the Introduction to the United Nations Model Convention. See, also, United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eighth session (15-19 October 2012), chapter III, section D, at page 11 (available at [http://www.un.org/ga/search/view\\_doc.asp?symbol=E/2012/45&Lang=E](http://www.un.org/ga/search/view_doc.asp?symbol=E/2012/45&Lang=E)).

<sup>12</sup>See paragraphs 10, 11 and 12 of the Commentary on Article 20 of the United Nations Model Convention.

Where a special provision dealing with fees for technical services or technical assistance is included in a tax treaty, it commonly treats the fees as, or in the same way as, royalties which, under the United Nations Model Convention, may be taxed at source at a limited rate agreed by the treaty partners. The scope of the provision and rate limits vary from treaty to treaty. However, the provisions are reasonably consistent in providing:

- That the fees are deemed to arise in the country of which the payer is a resident, or if borne by a permanent establishment or fixed base, in the country in which the permanent establishment or fixed base is situated
- The fees may be taxed in that country on a gross basis, albeit the rate of tax is limited where the fees are beneficially owned by a resident of the treaty partner country
- Business profits treatment will apply if the fees are attributable to activities carried on through a permanent establishment or a fixed base of the service provider situated in the source country.

Countries that seek to include these provisions will often have specific domestic law rules for the taxation of fees for technical services or assistance provided by non-residents. Many developing countries apply withholding tax to payments for such services. For these countries, the main issues that arise in administering the treaty provisions relate to the determination of the services to which the treaty provisions apply (if their scope is different from their domestic law provision) and to the identification of the beneficial owner of the fees for purposes of determining whether any reduction in source taxation is applicable.<sup>13</sup> Other issues arise for tax administrations of countries that do not apply withholding tax to such payments. These include identification of relevant payments, and application of tax rate limitations based on the gross amount of the payment.

Under the United Nations Model Convention, remuneration of visiting teachers is dealt with under different articles, depending on

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<sup>13</sup>Issues relating to beneficial ownership are discussed in chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold, chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler, and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

the capacity in which the teaching services are performed, that is to say, Article 14 for independent teaching services, Article 15 for employed teachers, or Article 19 for teachers employed by a government. Some countries, however, prefer to encourage cultural relations and the exchange of knowledge by including a special article in their treaties that provides an exemption from source taxation for the remuneration of teachers (including professors and, sometimes, researchers) who visit the country for less than a specified period (often two years).

While no specific provision dealing with remuneration of teachers is included in the United Nations Model Convention, the Commentary discusses a number of issues that should be considered in bilateral negotiations when drafting such a provision.<sup>14</sup> For example, to avoid double non-taxation, the treaty may provide that exemption is conditional on the remuneration being subject to tax in the teacher's country of residence. The exemption may also be conditional on the teaching activities being performed at recognized teaching institutions and/or not being for private benefit.

Nevertheless, provisions relating to teachers are notoriously difficult to administer. Competent authorities or tax administrations are commonly called upon to determine whether remuneration derived from teaching activities that exceed the specified period should be taxed from the beginning of the visit or only from the expiration of the specified period. They are also required to decide whether the exemption applies to remuneration from subsequent visits, or only the first one. It may also be difficult to determine whether the person performing the services should be regarded as a teacher, for example, where a person such as a tutor does not hold relevant teaching qualifications.

A few countries interpret the definition of "royalties" in Article 12 in a way that would permit source taxation of income from services. Such interpretations can create administrative difficulties with respect to characterisation of income and to source of the income.

Rarely, a country may take the view that services income may fall within Article 21 as income that is not otherwise dealt with under

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<sup>14</sup>See paragraphs 11 and 12 of the Commentary on Article 20 of the United Nation Model Convention.

the treaty. On this view, since Article 21 of the United Nations Model Convention permits taxation by a country of income arising from sources in its territory, tax could be imposed on services income where it is considered to have a source in that country under domestic law.

## **2. Administrative issues**

It is obvious from the discussion above that treaties do not provide a consistent approach to tax treatment of income from services. In determining the correct tax treatment applicable under a treaty provision, tax administrations may need to consider one or more of a number of different factors. These include:

- Whether the income is derived by a resident of a treaty partner country who is entitled to treaty benefits
- The character of the income, that is to say the type of services provided, and whether provided by an individual or a legal person
- Whether service activities are sourced in the country, for example, exercised in that country or paid by a resident
- Whether any applicable threshold for source taxation has been met
- The amount of income that may be taxed in the source country
- The method of imposing or collecting tax.

### **2.1 Residence of service provider**

Treaties apply to persons who are residents of one or both of the treaty partner countries.<sup>15</sup> For tax authorities, therefore, the first step in deciding whether treaty benefits are available in respect of income from services derived from sources in one country is to determine whether the service provider is a resident of the other country for treaty purposes. The issues relating to determination of residence for treaty purposes are dealt with in another chapter.<sup>16</sup>

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<sup>15</sup>Article 1 of both the United Nations and OECD Model Conventions.

<sup>16</sup>See chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler.

For certain categories of services income, a service provider who is a resident of a treaty partner country must fulfil additional criteria for entitlement to treaty benefits in respect of that income.

For purposes of Article 7, Business profits, the service provider must be carrying on an enterprise. The term “enterprise” is not defined in itself in the United Nations Model Convention.<sup>17</sup> It is clear, however, that source taxation is only permitted if the non-resident service provider is carrying on business in that country through a permanent establishment. The term “business” is not defined in the United Nations Model Convention and is defined in the OECD Model Convention only to include professional and other independent services. Tax authorities should determine whether or not the service provider is carrying on an “enterprise” or a “business” by reference to domestic law.

Under Article 8, Shipping, inland waterways transport and air transport, treaty benefits (i.e. exemption from source taxation) will only be available if the place of effective management of the transport enterprise is outside the source country. Determination of the “place of effective management” can be a complex matter, involving the consideration of factors such as where the enterprise is actually managed and controlled, where its board of directors meets, where the highest level of decision-making takes place.

Many countries prefer to assign exclusive taxing rights under the treaty to the country of which the shipping or airline enterprise is a resident, rather than the country where its place of effective management is located.<sup>18</sup> This may be a policy preference, or may reflect

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<sup>17</sup>See paragraph 6 of the Commentary on Article 3 of the United Nations Model Convention. Article 3 (1) (c) of the OECD Model Convention provides that the term enterprise “applies to the carrying on of any business”. However, as clarified in paragraph 4 of the Commentary on Article 3 of the OECD Model Convention, no exhaustive definition of the term “enterprise” was attempted in the Article, as the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise is generally interpreted according to domestic law.

<sup>18</sup>See paragraph 2 of the Commentary on Article 8 of the OECD Model Convention.

concerns about administrative difficulties in determining the place of effective management, especially in countries where this concept does not have a domestic law equivalent. Tax administrations will generally have few difficulties in obtaining the information necessary to verify that an enterprise is a resident of one or other country. Similarly, international transport enterprises that are residents of a State would have little difficulty in obtaining a certificate of residence to that effect in their home country when claiming treaty benefits.

For purposes of Article 12, Royalties, and/or Fees for technical services provisions, only a resident of a treaty partner country who is also a “beneficial owner” of the royalties or fees is entitled to treaty benefits. The meaning of “beneficial owner” and the issues arising for tax authorities are discussed in other chapters.<sup>19</sup>

Under Article 19, Government service, exemption from tax in the paying State on remuneration from government services performed in the other country applies only to residents of that other country if that person is:

- A national of that other country, or
- Did not become a resident of that other country solely for the purpose of rendering the services.

This exemption commonly applies to locally-engaged staffs who are employed by foreign diplomatic missions or consular posts in a country. The tax authorities of the paying country will ordinarily have few difficulties in determining whether the recipient is a resident and national of the other country. However, where the government employee is not a national of the treaty partner country, determining that person’s reasons for becoming a resident of that country may sometimes present difficulties, particularly when the date of the employee’s arrival in that country is close to the time at which they commenced government service in that country.

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<sup>19</sup>See chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold, chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler, and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

Exemption under Article 20, Students, applies to a student or business trainee or apprentice who “is or was immediately before visiting a country” a resident of the treaty partner State. It follows that exemption may apply, even though the visiting student or trainee has ceased to be a resident of the other country during his visit (for example, has become a resident of the visited country). However, the student or trainee must be visiting the country “solely for the purpose of his education or training”. Tax authorities should apply this condition in a reasonable manner. For example, exemption should not be denied merely because a student or trainee visited friends or relatives, or took a short vacation, during his visit.

## 2.2 Characterization of income

One of the most difficult administrative issues faced by tax authorities is the characterization of services income for purposes of determining which article of the treaty applies. Article 7, Business profits, is the provision that generally applies to income from services. Income from the provision of services, other than services provided as an employee, by an enterprise to another person, would generally constitute profits of an enterprise for purposes of Article 7. However, priority is given to other articles to the extent that the income is dealt with under those other articles in the treaty,<sup>20</sup> subject to the throwback rules in some articles.<sup>21</sup> Accordingly, different types of services income must be distinguished for purposes of determining whether another more specific article of the treaty applies.

The application of the more specific provisions generally depends on the nature of the services provided. Under some articles, the classification of the service provider, for example, as a director or as a teacher, may also be relevant. Some of the more common characterization issues are discussed below.

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<sup>20</sup>Article 7 (6) of the United Nations Model Convention and Article 7 (4) of the OECD Model Convention.

<sup>21</sup>See Articles 10 (4), 11 (4), 12 (4) and 21 (2) of the United Nations Model Convention and Articles 10 (4), 11 (4), 12 (3) and 21 (2) of the OECD Model Convention.

### 2.2.1 Nature of the services

Article 8 applies to “profits from the operation of ships or aircraft in international traffic”. A challenge for tax authorities is to determine which activities would fall within the scope of the provision. In addition to the carriage by ship or aircraft in international traffic of passengers or cargo, enterprises may carry on a range of related activities, such as baggage handling, maintenance, ground transport, container leasing, and so on. Notwithstanding the guidance in the Commentaries to the Model Conventions,<sup>22</sup> the exact scope of Article 8 in its application to profits from non-transport activities carried on by these enterprises is not always clear.

The definition of “royalties” in Article 12 of the United Nations Model Convention includes payments for information concerning industrial, commercial or scientific experience (know-how). While fees for technical services and assistance are generally not regarded as falling within the scope of this definition,<sup>23</sup> the United Nations Commentary notes that “some countries tend to regard the provision of brain-work and technical services as the provision of ‘information concerning industrial, commercial or scientific experience’ and to regard payment for it as royalties”.<sup>24</sup> Countries that take this view should clarify this during negotiations.

In some treaties, the term “royalties” in Article 12 is specifically extended to cover fees for technical services or technical assistance, or a separate Fees for technical services article, which follows the basic form of the royalties article, is included.

Difficulties are often encountered in determining whether payments should be characterized as fees for technical services or

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<sup>22</sup>Paragraphs 4–14 of the Commentary on Article 8 of the OECD Model Convention, and paragraphs 10 and 11 of the Commentary on Article 8 of the United Nations Model Convention, quoting paragraphs 4–14 of the Commentary on Article 8 of the OECD Model Convention.

<sup>23</sup>Paragraphs 11.1–11.6 of the Commentary on Article 12 of the OECD Model Convention, and paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraphs 11.1–11.6 of the Commentary on Article 12 of the OECD Model Convention.

<sup>24</sup>Paragraph 14 of the Commentary on Article 12 of the United Nations Model Convention.

assistance, so as to come within the scope of the provision. Although the terms are not usually defined, “technical services” often include, explicitly or by interpretation, any services of a technical, managerial or consultancy nature. The term “technical assistance” is often used in the context of services connected with the development and/or transfer of technology. However, the precise meaning of these terms is not clear and understanding of the scope of each term differs from country to country. For this reason, it is important that negotiators try to clarify their meaning during negotiations. If different understandings arise after the treaty has entered into force, tax authorities should seek an agreed understanding of the term through the mutual agreement procedure.

The application of Article 14, Independent personal services, requires a determination of whether activities constitute “professional services or other activities of an independent character”. These are usually regarded as services provided by an individual for the performance of activities in an independent capacity. Payments to an enterprise in respect of furnishing of services through its employees or other personnel are covered by Article 5 and Article 7.<sup>25</sup> However, some countries consider that the provisions of Article 14 can also extend to activities of legal entities.<sup>26</sup>

Article 14 does not apply to industrial or commercial activities, or services performed in employment or as an artiste or sportperson.<sup>27</sup> An illustrative list of professional services is provided in Article 14 (2). However, the application of the Article is not limited to the enumerated professional services. Difficulties as to covered services may be resolved through the mutual agreement procedure.<sup>28</sup>

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<sup>25</sup>Paragraph 9 of the Commentary on Article 14 of the United Nations Model Convention.

<sup>26</sup>Ariane Pickering, *Enterprise Services*, General Report, in International Fiscal Association, vol. 97a Cahiers de droit fiscal international (The Hague, The Netherlands: Sdu Uitgevers, 2012) at p.45.

<sup>27</sup>Paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraph 1 of the former Commentary on Article 14 of the OECD Model Convention prior to deletion of Article 14 in 2000.

<sup>28</sup>Paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraph 1 of the former Commentary on Article 14 of the OECD Model Convention prior to deletion of Article 14 in 2000.

It should be noted that, in treaties that include provisions for source taxation of technical services, there is potential for overlap between services covered by such provisions and those covered by Article 14. This may need to be resolved through the mutual agreement procedure if the treaty does not provide a priority rule.

The application of Article 15, Dependent personal services, requires that the income be derived from employment services, that is to say, remuneration for services rendered to another person in the course of employment. It is important to distinguish between employment services (to which Article 15 applies) and services provided by one enterprise to another (to which Article 7 or Article 14 applies). It is also important to correctly identify the person who is the “employer” for purposes of this Article (which may be different from the person who is regarded as employer under domestic tax or labour law). Difficulties can especially arise where the services, while performed under a formal contract of employment between the individual and a non-resident enterprise, are rendered to a person who is a resident. Guidance on these difficult issues can be found in the Commentaries.<sup>29</sup>

Article 19, Government service, applies to services provided by State employees in the course of their employment, and to pensions from such employment. It does not apply to independent personal services provided to a State (which would fall within the scope of Article 14 of the United Nations Model Convention).<sup>30</sup> Nor do the provisions apply to services rendered in connection with a business carried on by a government. The usual rules provided with respect to income from dependent or independent personal services, or entertainment activities, apply to remuneration from services rendered in connection with a government business.<sup>31</sup>

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<sup>29</sup>Paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention, and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention.

<sup>30</sup>See paragraph 2.1 of the Commentary on Article 19 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 2.1 of Commentary on Article 19 of the OECD Model Convention.

<sup>31</sup>Article 19 (3) of the United Nations Model Convention.

### 2.2.2 Qualification of service provider

A number of articles characterise income according to the qualification of the person deriving the income, for example, income derived by a director or top-level manager (Article 16), an artiste or sportsperson (Article 17), a student, business trainee or apprentice (Article 20), or a teacher or professor (teachers' article).<sup>32</sup> In each case, the recipient of the income must derive the relevant income from the performance of services in their capacity as such a person.

Tax authorities must first determine whether the person qualifies as the relevant kind of service provider. Although the various terms are not defined in treaties, the Commentaries provide guidance on the meaning of several of them. In other cases, the tax authority would need to determine qualification through mutual agreement with the competent authority of the treaty partner country, or by reference to domestic law.

In determining which company officials would qualify as a top-level manager for purposes of Article 16 of the United Nations Model Convention, the relevant Commentary notes that “the term ‘top-level managerial position’ refers to a limited group of positions that involve primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors. The term covers a person acting as both a director and a top-level manager”.<sup>33</sup>

The Commentaries on Article 17 of the United Nations and OECD Model Conventions provide guidance on the meaning of “artiste” and “sportsman” or “sportsperson”. The Article applies to performers whose activities are of an entertainment character, including actors, athletes, participants in sports such as tennis, golf and car racing or other entertainment activities such as billiards, chess or bridge tournaments. It generally does not apply to conference speakers

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<sup>32</sup>Article 15 does not refer specifically to income of “employees”, but it applies to income derived “in respect of employment” paid by an “employer”. See *supra* section 2.2.1.

<sup>33</sup>Paragraph 5 of the Commentary on Article 16 of the United Nations Model Convention.

or administrative or support personnel.<sup>34</sup> The Commentaries also offer guidance on which activities of such persons would give rise to income that falls within the scope of the Article.<sup>35</sup> The Article applies to income of all entertainers, whether they are private or government employees, or providing independent services.

For the purposes of Article 20, whether a person will qualify as a “student or business trainee or apprentice” will depend on the domestic law of the country applying the treaty. Tax authorities of the visited country will also need to determine whether the payments received are for the purpose of the recipient’s “maintenance, education or training”. Such payments need to be distinguished from payments for services, which are dealt with under Article 15, Article 7 or Article 14. Guidance on this issue is provided in the relevant Commentaries.<sup>36</sup>

In treaties that include an article regarding teachers, the question whether a person qualifies as a teacher for purposes of the article can be troublesome. Some countries consider that only income from the teaching activities of persons who hold formal qualifications as a teacher is dealt with under the article. Other countries take a wider view of the scope of the article and apply its provisions to any person performing teaching activities.

### 2.3 Source of income

Under many treaty provisions, the right to tax on a source basis will depend on the services being performed within the country. However,

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<sup>34</sup>See paragraphs 3-7 of the Commentary on Article 17 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraphs 3-7 of the Commentary on Article 17 of the OECD Model Convention.

<sup>35</sup>See paragraphs 8 and 9 of Commentary on Article 17 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention quoting paragraphs 8 and 9 of Commentary on Article 17 of the OECD Model Convention.

<sup>36</sup>Paragraph 3 of the Commentary on Article 20 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 20 of the United Nations Model Convention, quoting paragraph 3 of the Commentary on Article 20 of the OECD Model Convention.

this is not always the case. Source taxing rights may also be allocated to a country under some treaty provisions where the payer is a resident of that country (for example, in the case of directors' fees, or fees for technical services). Services income that is attributable to a permanent establishment or fixed base situated in a country may also be taxed in that country. In applying a treaty provision with respect to income from services, tax authorities should, therefore, be aware of the basis on which a source taxing right is allocated and determine whether the relevant nexus exists.

It should be noted that, whatever the treaty rule may be for allocating taxing rights, countries may only exercise that right to the extent that their domestic law permits. The allocation of a taxing right under the treaty does not authorize a country to tax income that would otherwise not be subject to tax under domestic law. Accordingly, in applying source taxing rights allocated under the treaty, tax authorities should also take into account whether the income would be regarded as having a source in their country under domestic law.

### **2.3.1 Place of performance**

Under the United Nations Model Convention, the place in which the services are performed is relevant to the application of Article 5, Article 8, Article 14, Article 15, Article 17 and Article 19.

For purposes of the deemed services permanent establishment provision in Article 5 (3) (b) of the United Nations Model Convention, tax authorities will need to determine whether activities involving the furnishing of service continue "within a Contracting State" for the requisite period. Article 14 (1) (b) also requires that the services be "performed" in the source State, while Article 15 and Article 17 refer respectively to employment and personal activities "exercised" in that State. Article 19 refers to services "rendered" in a State. Notwithstanding the different terminology used in these Articles, it is generally accepted that in each case the provisions require the performance of services by individuals who are physically present in the country. Although the Commentary on Article 5 of the United Nations Model Convention does not discuss this requirement in Article 5 (3) (b), in most countries the provision is interpreted as meaning that the services must be

physically performed in the source State.<sup>37</sup> A few countries, however, do not agree with this interpretation. India, for example, takes the view that “physical presence of an individual is not essential”.<sup>38</sup> Under this latter interpretation, services performed outside the relevant State may be regarded as having been furnished within that State, for example, if they are performed for the benefit of a resident. Given the very different treatment that may result from the application of these two interpretations, it is highly desirable that a common understanding on this matter be reached during negotiations. The OECD’s alternative provision deeming a services PE<sup>39</sup> explicitly provides that the services must be “performed” in the source State. The Commentary further states as a principle that source taxation “should not extend to services performed outside the territory of a State”.<sup>40</sup>

In applying Article 5 (3) (b), as well as Article 14 (1) (b) and Article 17, the main challenge for tax authorities is in identifying when services are being performed in their territory, particularly in the case of mobile services activities. Information concerning service activities performed in a country by non-residents may be available, in the case of services provided to a resident enterprise or a permanent establishment situated in that country, in the records of those enterprises that claim deductions in respect of the payments. However, this imposes a substantial administrative burden on tax authorities and would not be effective in the case of services provided to non-business consumers who do not claim such deductions.<sup>41</sup> Another approach adopted in many countries is to require that individuals or enterprises that carry on taxable activities within their jurisdiction obtain and quote

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<sup>37</sup>Ariane Pickering, *Enterprise Services*, General Report, in International Fiscal Association, vol. 97a Cahiers de droit fiscal international (The Hague, The Netherlands: Sdu Uitgevers, 2012) at p.39.

<sup>38</sup>India’s position on paragraph 42.31 of the Commentary on Article 5 of the OECD Model Convention.

<sup>39</sup>See paragraph 42.23 of the Commentary on Article 5 of the OECD Model Convention.

<sup>40</sup>Paragraph 42.22 of the Commentary on Article 5 of the OECD Model Convention.

<sup>41</sup>See paragraph 42.12 of the Commentary on Article 5 of the OECD Model Convention.

a taxpayer identification number, or business identification number. This may assist tax authorities in tracking this income. Similarly, information provided to relevant authorities under any business registration requirements may, if available to tax administrations, help the administration to identify non-residents carrying on business within a country.

The definition of permanent establishment in Article 5 (1) of both the United Nations and OECD Model Conventions requires the existence of a fixed place of business through which the business of the enterprise is carried on. Where such a fixed place of business exists, the country in which it is situated may tax profits attributable to that place in accordance with Article 7. Similarly, Article 14 (1) (a) of the United Nations Model Convention allows source taxation of independent personal services income attributable to a fixed base of the service provider.

In neither case does the treaty specifically provide that services must be performed in the State in which the fixed place of business or fixed base is situated. While services provided through a fixed place of business or fixed base would usually be performed in the country in which that fixed place or fixed base is situated, countries take different views as to whether income from services performed outside their jurisdiction could be attributed to a fixed place of business or fixed base.<sup>42</sup> Whatever view tax authorities take on this matter, source tax may only be imposed in a country if the income would otherwise be subject to tax in that country (for example, because it is regarded as having a source in that country) in accordance with domestic law. Countries that seek to attribute to a fixed place of business, or a fixed base, income from services performed in another country, are likely to encounter practical difficulties in identifying those services, particularly where the services are provided to a non-resident.

Source taxation of employment income under Article 15 depends, in the first instance, on whether the employment is exercised in a country, although the residence of the payer (employer) is also

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<sup>42</sup> Ariane Pickering, *Enterprise Services*, General Report, in International Fiscal Association, vol. 97a *Cahiers de droit fiscal international* (The Hague, The Netherlands: Sdu Uitgevers, 2012) at p.56.

relevant to the determination of entitlement to source-tax exemption in the case of certain short-term visits. If the employment is not exercised in a country, a non-resident employee is entitled to exemption from taxation in that country on that remuneration. Determination of where employment is exercised may not always be a simple matter, especially if the employee is not required to provide his or her services at a particular workplace such as an office. However, an employee who seeks exemption from taxation in the country where employment is exercised may be expected to keep detailed records of where his or her employment duties were performed.

For purposes of Article 8, the place in which the transport services are performed is relevant in that it is necessary to determine whether ships or aircraft are operated “in international traffic”. The term “international traffic” is defined in Article 3, General definitions, of the United Nations Model Convention to mean any transport by ship or aircraft operated by an enterprise that has its place of effective management in a treaty partner country, unless the ship or aircraft is operated solely between places in the (source) country. As a result of this broad definition, the rules provided in Article 8 apply not only to profits from international transport between countries, but also to profits from domestic transport within the country in which the enterprise has its place of effective management, or from domestic transport within a third country.

The source State, in deciding whether to exempt the profits in accordance with Article 8 (alternative A) or to reduce its tax in accordance with Article 8 (alternative B), must determine whether, on the particular voyage that gave rise to those profits, the ship or aircraft on which the transport was provided was being operated in international traffic. Tax authorities will therefore need to determine, in relation to each voyage of each ship or aircraft operated by a foreign enterprise, whether that voyage was confined to places within their country.<sup>43</sup> If the ship or aircraft was being operated solely between places in the

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<sup>43</sup>A ship or aircraft that operates solely between places in a State would not be regarded as being used in international traffic, notwithstanding that part of that journey may take place outside that State, for example, in international waters. See paragraph 6.3 of the Commentary on Article 3 of the OECD Model Convention.

country, then Article 7, and not Article 8, will apply with respect to the income. The foreign enterprise should be able to produce shipping records of each voyage in respect of which exemption from tax is claimed under Article 8. However, the compliance and administrative burden involved in identifying which voyages are in international traffic, and the income derived in the source country from such voyages, is likely to be significant.

Some countries may find it easier to determine whether the journey of the passenger or cargo is confined to places within their territory, irrespective of whether the voyage is made on a ship or aircraft that is operated solely between places in that territory or is used for a voyage in international traffic. If information is more readily available concerning the journey of the passenger or cargo, rather than the journey of the ship or aircraft, these countries may prefer to use in their treaties the alternative formulation of the definition of “international traffic” set out in paragraph 6.2 of the OECD Commentary on Article 3.

### **2.3.2 Residence of payer**

Under Article 16, source taxing rights are allocated to the residence country of the company of which the recipient is a director or high-level manager. The place where the activities of the director or high-level manager are performed is irrelevant.

Whether or not a country can exercise this taxing right will depend on domestic law. The domestic law of many developing countries imposes withholding tax on fees paid to non-resident directors and/or managers of resident companies. However, in some countries, a non-resident director or manager whose activities are performed outside that country would not be liable for tax on his or her remuneration, notwithstanding that the company of which they are a director or manager is a resident of that country. The allocation of a taxing right under the treaty would not, in these circumstances, give rise to a tax liability.

The residence of the payer of the income is also relevant for determining source of services income that falls under Article 12 or a Fees for technical services treaty provision. Under these provisions,

the income is deemed to arise in the country of which the payer is a resident, or if the fees are borne by a permanent establishment or fixed base, in the country where the permanent establishment or fixed base is situated. Such provisions may give rise to administrative complexities, particularly for countries that do not tax fees for technical services by withholding under their domestic law. In these cases, the source of the income for treaty purposes is likely to differ from the source as determined under domestic law. For example, under domestic law, fees for such services may be treated as having a source in a country, and be taxable therein, only if the services are performed in that country. In these countries, information as to the residence of the payer of the fees may not be readily available. It may, therefore, be difficult to determine whether source taxing rights are governed by Article 12 or a Fees for technical services provision (in cases where the fees are paid by a resident or borne by a permanent establishment or fixed base) or by Article 7 (in other cases where the technical services are performed in the country).

The residence of the payer is also relevant to determining whether an exemption from source taxation applies in respect of employment income covered by Article 15. One of the three conditions that must be met in order for exemption to apply under Article 15 (2), is that the employer must not be a resident of the country in which the employment is exercised. Some treaties go further and require that the employer be a resident of the same country as the employee in order for the exemption to be granted.

An employee claiming exemption under this provision may not be in a position to provide the necessary evidence as to the residential status of his or her employer. However, the tax administration should have information as to whether the employer is a resident of the source country (and thus, by default, whether it is not a resident). For treaties that only exempt the employment income if the employer is a resident of the same country as the employee, information as to where the employer is a resident may not be readily available to either the employee or the tax administration of the country in which the services are performed. In these circumstances it may be necessary to seek confirmation of the employer's residential status in the other country through the exchange of information process.

Particular difficulties in the administration of Article 15 can arise in cases where an employee is in a formal contractual employment relationship with a non-resident enterprise but whose services are provided for the benefit of a resident enterprise. It is important therefore to correctly identify who is the “employer” for purposes of applying the exemption under Article 15 (2).<sup>44</sup>

Also, to be exempt under Article 15 (2), the remuneration must not be borne by a permanent establishment situated in that State. While the accounts of any permanent establishment of the employer would generally reflect whether or not this is the case, again this information may not be available to an employee who is seeking treaty benefits under this Article. It should, however, be accessible by the tax authorities.

For purposes of Article 20, payments received by students, trainees and apprentices will only be exempt if the payments “arise from sources outside” the visited country. Payments made from abroad will normally be from sources outside the country. However, the Commentary makes it clear the payments made by or on behalf of a resident of the visited country, or borne by a permanent establishment situated in that country, are not considered to arise from sources outside that country.<sup>45</sup>

## 2.4 Thresholds

Some treaty provisions allow source taxation of certain types of services income without any minimum threshold conditions, for example, Article 16, Article 17 and Article 19. Other provisions dealing with income from services provide a variety of threshold conditions for source taxation. These include:

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<sup>44</sup>See paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention, and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention.

<sup>45</sup>Paragraph 4 of the Commentary on Article 20 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 20 of the United Nations Model Convention, quoting paragraph 4 of the Commentary on Article 20 of the OECD Model Convention.

- Existence of a fixed place of business or fixed base
- A time threshold, which may relate to presence of the service provider in the source country or periods during which services are provided in that country
- Level of business activities
- Monetary threshold.

Conversely, exemption from source taxation may only apply where thresholds are not exceeded, or where other conditions are met.

#### **2.4.1 Fixed place of business or fixed base**

Source taxation under Article 7, Business profits, depends on the existence of a permanent establishment in that country. A permanent establishment is created under Article 5 (1) where the service provider has a fixed place of business through which the activities are performed. Similarly, Article 14 (1) (a) allows source taxation where the service provider has a fixed base available to him for the purpose of performing his independent personal services.

The need to establish the existence of a permanent establishment or fixed base is also relevant to taxation of services income under Article 15, Dependent personal services, in that the exemption provided under paragraph 2 of that Article will not apply if the employment remuneration is borne by a permanent establishment. For treaties that tax services income under Article 12, Royalties, or a Fees for technical services Article, the permanent establishment and fixed base concepts are relevant to determination of source. Furthermore, those provisions do not apply to income which is effectively connected with a permanent establishment or fixed base.

The administrative challenges involved in determining the existence of a fixed place of business permanent establishment are discussed in a separate chapter<sup>46</sup> and will not be discussed further in this chapter.

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<sup>46</sup>See chapter V, Taxation of non-residents on business profits, by Jinyan Li.

The same considerations would also apply to the determination of a fixed base. Although a few countries consider there is a difference between the concept of permanent establishment and that of fixed base, the two are generally regarded as identical.<sup>47</sup> The Commentary on former Article 14 of the OECD Model Convention notes that “there were no intended differences between the concept of permanent establishment ... and fixed base”.

#### 2.4.2 Time threshold — Presence of service provider

The amount of time the service provider spends in a country may be relevant to the determination of taxation in that country. Article 14 (1) (b) allows for source taxation where the service provider’s stay in the (source) State is for “a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period”. The same time threshold is also relevant to the determination of an employee’s entitlement to exemption from source taxation under Article 15 (2) and to the existence of a permanent establishment under paragraph (a) of the OECD’s alternative deemed services PE provision.<sup>48</sup>

Although the provisions refer respectively to the service provider’s “stay” in the source country in Article 14 (1) (b) and to the employee being “present” in that country in Article 15 (2) (a) and the OECD alternative deemed services PE provision, the concepts are the same. In all of these provisions, the time threshold refers to days in which the person is in the source State. The time threshold in these provisions refers to the physical presence of the person in the country, and not to the number of days during which services are performed or employment is exercised in the source State.<sup>49</sup> The requirement is therefore only to determine the number of days during which

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<sup>47</sup>Ariane Pickering, *Enterprise Services*, General Report, in International Fiscal Association, vol. 97a Cahiers de droit fiscal international (Sdu Uitgevers, The Hague, The Netherlands, 2012) at p.46.

<sup>48</sup>Paragraph 42.23 of the Commentary on Article 5 of the OECD Model Convention.

<sup>49</sup>See Article 5 (3) (b) of the United Nations Model Convention where the time threshold refers to the number of days during which the service activities are performed.

the person is present in the source country, which may occur over a number of visits, in any twelve-month period beginning or ending in the relevant fiscal year. This can be relatively easily documented by the taxpayer, for example, through passport entries or other immigration records. A day during any part of which the person is present in the country counts as a day of presence.<sup>50</sup>

However, days during which the person is a resident of that country for purposes of the treaty are not taken into account.<sup>51</sup> In this regard, it is important to note that, while a person may be regarded as a resident for domestic tax purposes, the tie-breaker rules may deem that person to be a resident only of the other country for treaty purposes.

### **2.4.3 Time threshold — Days during which services are performed**

Under some articles, source taxation of services income is dependent on a time threshold that relates to the number of days during which the services are rendered in that country, rather than on the presence of the service provider. The existence of a deemed services PE under Article 5 (3) (b) requires, in relation to the furnishing of services by an enterprise, that “activities of that nature continue (for the same or a connected project) within the (source) State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned”. Similarly, paragraph (b) of the OECD’s alternative services PE provision uses the same time threshold in relation to services performed by an enterprise in a country for the same or a connected project.

Under both provisions, the time threshold must be applied to services performed “for the same or a connected project”. The Commentary on Article 5 of the OECD Model Convention explains that connected projects covers separate projects carried on by an

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<sup>50</sup>Paragraph 5 of the Commentary on Article 15 of the OECD Model Convention, and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraph 5 of the Commentary on Article 15 of the OECD Model Convention.

<sup>51</sup>Paragraph 5.1 of the Commentary on Article 15 of the OECD Model Convention, and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraph 5.1 of the Commentary on Article 15 of the OECD Model Convention.

enterprise where those projects have a commercial coherence. Factors that are generally relevant to this determination are also set out in the Commentary.<sup>52</sup>

In applying either provision, it should be noted that the time threshold applies to the number of days during which services are performed by the enterprise. The services may be performed on behalf of the enterprise through one individual or through many. Each day on which the enterprise performs services in the country through at least one individual may be counted towards the threshold.<sup>53</sup>

A time threshold is also relevant for the purposes of Article 5 (3) (a), which deems a permanent establishment to exist in respect of building sites, construction projects, etc., and supervisory activities connected with such sites or projects, but only if the site, project or activities “last more than six months”. In this case, the site, project or activities commence on the first day on which the enterprise begins its work in the country and continue until the work is completed or permanently abandoned.<sup>54</sup> The number of days during which building or other services are actually performed is not relevant.

#### **2.4.4 Other thresholds**

The level of business activities conducted in the source country is relevant to the application of paragraph 2 of Article 8 (alternative B). Application of this provision requires a determination of when shipping activities in a country are “more than casual”. In this context, this expression means “a scheduled or planned visit of a ship to a particular country to pick up freight or passengers”,<sup>55</sup> which is likely to cover virtually all commercial transport operations by ship in a country.

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<sup>52</sup>Paragraph 42.41 of the Commentary on Article 5 of the OECD Model Convention.

<sup>53</sup>Paragraph 42.39 of the Commentary on Article 5 of the OECD Model Convention.

<sup>54</sup>Paragraph 19 of the Commentary on Article 5 of the OECD Model Convention, and paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 19 of the Commentary on Article 5 of the OECD Model Convention.

<sup>55</sup>Paragraph 13 of the Commentary on Article 8 of the United Nations Model Convention.

A few treaties include a monetary threshold for source taxation, for example, in Article 14 or Article 17. In these treaties, source taxation is only permitted where the income received by the non-resident exceeds a specified amount. Administration of such thresholds presents particular difficulties where tax is collected by withholding, since the payer may have little knowledge of the total income derived by the service provider from sources in the country.

## **2.5 Amount of income taxable in source country**

Once any threshold for source taxation has been met, a determination of the amount of income that may be taxed in that country must be made. In the first place, tax authorities must determine whether deductions for expenses should be allowed. They must then consider how the amount of income that may be taxed in the source country should be calculated, having regard to any limitations that the treaty may place on source taxation.

### **2.5.1 Deductions for expenses**

For purposes of Article 7, Business profits, only “profits” of the enterprise may be taxed in the source country. The reference to “profits” makes it clear that source tax may only apply to the net amount, after deduction of relevant expenses,<sup>56</sup> derived by the enterprise from its activities carried on through the permanent establishment. Article 7 (3) of the United Nations Model Convention provides that the expenses in respect of which deductions must be allowed are those that are incurred for the purposes of the business of the permanent establishment, including executive and general administrative expenses. Under the United Nations Model Convention, no deduction is allowed for

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<sup>56</sup>Paragraph 30 of the Annex to the Commentary on Article 7 of the OECD Model Convention, and paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 30 of the Annex to the Commentary on Article 7 of the OECD Model Convention, note that “paragraph 3 only determines which expenses should be attributed to the permanent establishment”. Deductibility of those expenses is determined by domestic law, subject to the rules of Article 24, Non-discrimination. Conditions for deductibility may include specific compliance requirements with respect to claiming or substantiating expenses.

amounts paid between a permanent establishment and its head office in respect of royalties, interest or services except as reimbursement of actual expenses. Guidance on the application of Article 7(3) is provided in the Commentaries.<sup>57</sup>

Other treaty articles dealing with taxation of income from services are silent on the question of whether deduction of expenses must be allowed. Article 14 and Article 17 refer to “income”, while Article 15, Article 16 and Article 19 refer to amounts such as salary, wages, remuneration or directors’ fees or similar payments.

Although the Commentary on Article 14 states that expenses should be allowed in determining the income attributable to a fixed base,<sup>58</sup> this practice is not followed in all countries. Some countries tax income from independent personal services on a gross basis.<sup>59</sup> No guidance is provided in the Commentaries on the above-mentioned other Articles as to whether deductions must be allowed in respect of expenses incurred in deriving the relevant income. In these cases, the domestic law of the source country will determine the extent, if any, to which deductions are allowed for expenses.<sup>60</sup>

### 2.5.2 Limitations

Under Article 7, only profits that are “attributable to” a permanent establishment may be taxed in the country in which that PE is situated.

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<sup>57</sup>Paragraphs 16-18 of the Commentary on Article 7 of the United Nations Model Convention, and paragraphs 27-51 of the Annex to the Commentary on Article 7 of the OECD Model Convention. See also paragraphs 15-43 of the Commentary on Article 7 of the OECD Model Convention.

<sup>58</sup>Paragraph 3 of the former Commentary on Article 14 of the OECD Model Convention, and paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraph 3 of the former Commentary on Article 14 of the OECD Model Convention.

<sup>59</sup>Ariane Pickering, *Enterprise Services*, General Report, in International Fiscal Association, vol. 97a Cahiers de droit fiscal international (The Hague, The Netherlands: Sdu Uitgevers, 2012) at p.45.

<sup>60</sup>See paragraph 10 of the Commentary on Article 17 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraph 10 of the Commentary on Article 17 of the OECD Model Convention.

In treaties that include the force of attraction provisions of the United Nations Model Convention, profits that are attributable to service activities carried on in that country that are similar to those carried on through the permanent establishment may also be taxed.

Difficulties are often encountered in determining how much profit is attributable to the permanent establishment. While these are not significantly different in the case of services PEs from the problems of determining the profits attributable to services performed through a fixed place of business PE, they are nevertheless issues of concern to tax administrations. Attribution of profits to a permanent establishment is a complex issue and is beyond the scope of this chapter. Tax authorities should follow the guidance provided by the Commentary on Article 7 of the United Nations Model Convention or, if Article 7 of the OECD Model Convention (as of 2010) is adopted in a treaty, the guidance provided in the Commentary to that Article and the 2010 Report on the Attribution of Profits to Permanent Establishments.<sup>61</sup>

Article 14 (1) (a) limits source taxation to income that is “attributable to” a fixed base available to the independent service provider. The Commentary notes that the guidance for interpreting and applying Article 7 can also be used for the purposes of Article 14.<sup>62</sup>

For purposes of Article 15, the country in which employment is exercised may tax the employee’s remuneration, but only to the extent that it is derived from the employment exercised in that country. Accordingly, unless the employment is exercised wholly in the source State, it will be necessary to make a determination of how much of the employee’s remuneration may be taxed in the source State. A suitable method for making such a determination would be to apportion the individual’s income from that employment derived during the year, based on the number of days when the duties were performed in the

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<sup>61</sup>2010 Report on Attribution of Profits to Permanent Establishments, OECD, Paris, 2010, available at <http://www.oecd.org/ctp/transfer-pricing/45689524.pdf>.

<sup>62</sup>Paragraph 3 of the Commentary on former Article 14 of the OECD Model Convention, and paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraph 3 of the Commentary on former Article 14 of the OECD Model Convention.

country compared to the number of days when the employment was exercised outside that country.

Paragraph 2 of Article 8 (alternative B) permits source taxation of profits from shipping activities in a country, irrespective of the existence of a permanent establishment, and irrespective of whether the profits are attributable to any permanent establishment. However, an “appropriate allocation of the overall net profits” of the enterprise must be made.

The Commentary notes that the overall net profits should generally be determined by the tax authorities of the country in which the place of effective management of the enterprise is located (or the country of residence).<sup>63</sup> A notice of the tax assessment on the enterprise may be accepted as sufficient evidence of the home country’s determination of overall net profits. However, as noted in the Commentary,<sup>64</sup> some of the conditions of the determination, for example, the treatment of special allowances or prior year losses, may need to be negotiated between the two tax authorities. The mutual agreement procedure under Article 25 of the United Nations Model Convention would be a suitable method of reaching such agreement.

An appropriate allocation of the profit must also be agreed. This could be done as part of the treaty negotiations, for example, in an interpretive Protocol annexed to the treaty. It could also be agreed, either contemporaneously with or after the treaty negotiations, as a Memorandum of Understanding or Exchange of Notes. An administrative-level resolution under the mutual agreement procedure set out in Article 25 is also possible. Guidance in the Commentaries recommends allocation “based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions)”.<sup>65</sup>

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<sup>63</sup>Paragraph 14 of the Commentary on Article 8 of the United Nations Model Convention.

<sup>64</sup>*Ibid.*

<sup>65</sup>*Ibid.*

## 2.6 Method of taxation and collection

Tax treaties do not prescribe the method of taxation that should be adopted by countries in exercising taxing rights allocated to them under the treaty. Nor do they specify how the tax is to be collected. These matters will generally be determined in accordance with the domestic law of the country applying the treaty. The comments made in relation to Article 10, Dividends, in this regard are generally applicable to all articles, that is to say, the provision “lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws, and, in particular, to levy the tax either by deduction at source or by individual assessment”.<sup>66</sup>

### 2.6.1 Taxation by assessment

Many countries levy tax on services income derived in their country by non-residents on an assessment basis, either upon filing a tax return or by self-assessment. However, verification of income and expenses may be a challenge for tax administrations, as it is often difficult to obtain information about service activities performed in their country, especially where the services are not performed through a fixed place of business or a fixed base. Some countries impose an obligation on non-resident service providers to register their business when services are provided within the country. Others require that a copy of the contract for services be lodged with the tax administration. However, these obligations are often difficult to enforce.

To overcome such difficulties, developing countries frequently resort to the imposition of withholding taxes on service fees paid to non-residents. In some countries, this may be a final tax, but in others taxpayers are given the option of taxation by assessment upon filing a tax return (or other prescribed form).

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<sup>66</sup>Paragraph 18 of the Commentary on Article 10 of the OECD Model Convention, and paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 18 of the Commentary on Article 10 of the OECD Model Convention.

### 2.6.2 Withholding tax

Developing countries commonly require payers to withhold tax on a wide variety of payments under domestic law. For many such countries, withholding tax represents the only effective way of collecting tax on payments to non-residents. If, as is often the case under domestic law, the resident payer (or permanent establishment of a non-resident payer) is personally liable if they fail to withhold the appropriate tax, there is a significant incentive for the withholding agent to comply with the withholding tax requirements. The tax may be levied as a final tax or on an interim basis (that is to say, as an advance collection of tax). Where interim withholding is levied, the tax withheld is creditable against the taxpayer's final liability as assessed on the basis of net income disclosed in a tax return filed by the taxpayer.

Interim or final withholding tax is often levied on:

- Employment income (Article 15 or Article 19)
- Independent personal services income (Article 14)
- Directors' fees and remuneration of top-level managers (Article 16)
- Payments to artistes and sportspersons (Article 17)
- Payments made by residents and permanent establishments in respect of technical services (Article 12 or Fees for technical services provisions).

#### **Article 15, Dependent personal services, and Article 19, Government service**

Under the domestic law of many countries, resident employers (including government employers) are required to withhold tax from remuneration paid to employees, whether those employees are resident or non-resident. In most countries, the withholding is an interim withholding tax. In some countries, however, the tax withheld may represent a final tax.

Non-resident employers in the country where the employment is exercised may also be obliged to withhold tax on remuneration paid to employees. However, unless the employer is registered in the source country or has a permanent establishment situated therein, it may be difficult for tax administrations to enforce this obligation.

### **Article 14, Independent personal services**

In some countries, non-residents providing independent personal services in a country are required to register with the tax authorities. Nevertheless, most countries impose interim or final withholding tax on payments by residents and permanent establishment in respect of such services as a way of effectively collecting tax.

### **Article 16, Directors' fees and remuneration of top-level managerial officials**

Most countries require the paying company to withhold tax on directors' fees and remuneration of top-level managers. However, in some countries, the income will only be regarded as having a source (and, therefore, taxable therein) if the activities are performed in that country. In these countries, it is necessary to determine where and when the director's or top level manager's services are performed.

### **Article 17, Artistes and sportspersons**

Practice amongst countries differs on how entertainment income is taxed. In most countries, given the difficulties for tax administrations in knowing when an artiste or sportsperson is performing entertainment activities in the country, an obligation is imposed on the promoter of the entertainment or sporting event to withhold tax on payments to entertainers. This tax may be imposed on a final or non-final basis. Where the tax is a final tax based on the gross amount paid to the artiste or sportsperson, the rate imposed is generally relatively low. In some countries, an option for taxation on a net basis is provided under domestic law or under a treaty.

Even with a withholding tax, collection of tax liabilities of non-resident entertainers often presents problems. For example, enforcement of the obligation to withhold is particularly difficult where the promoter is a non-resident. While treaties can help in this regard through the inclusion of provisions for assistance in collection of tax,<sup>67</sup> few treaties negotiated by developing countries include such provisions.

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<sup>67</sup>Article 27 of the OECD Model Convention and Article 27 of the United Nations Model Convention.

## Technical fees

Technical fees paid to non-residents are often subject to a final withholding tax under domestic law. When Article 12, Royalties, and Fees for technical services provisions apply to such payments, the source country has the right to continue to tax the fees through a final withholding tax on the gross amount of the payment. If, however, the fees are derived through a permanent establishment or fixed base situated in the source State, they must be taxed in accordance with the rules applicable to business profits, that is to say, on a net basis. In countries where the fees would otherwise be taxed on a withholding basis under domestic law, mechanisms may not exist for applying net basis taxation to the fees. Tax administrations will need to ensure that procedures are in place to refund to service providers, who claim the benefit of this treaty provision and who provide information to enable determination of their net profit from the service activities, any tax withheld in excess of the tax payable on that profit.

Under the domestic law of many countries, however, fees for technical services or assistance are not a separate category of income or are not subject to withholding tax. In these countries, there may be further difficulties in applying special treaty provisions. If the domestic law does not distinguish for tax purposes between technical and other services, there are likely to be difficulties in identifying the services to which the treaty provision applies. It may also be difficult to apply a gross tax rate limit if the fees are ordinarily included in taxable income and taxed on a net basis in the source country.

### 2.6.3 Application of treaty limits

The OECD Commentary on Article 1 notes that “each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention”. The method that is “highly preferred” is to limit the tax that is levied to accord with the limits provided under the treaty.<sup>68</sup>

This can be problematic, however. For the purposes of Article 14, Independent personal services, for example, a withholding agent may

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<sup>68</sup>Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention.

not know how long the service provider will be present in the country and so will not be able to determine the service provider's entitlement to exemption. Furthermore, if withholding agents are liable for underpaid tax (as is commonly the case when the withholding tax represents the final tax liability of the service provider), the agent is unlikely to refrain from collecting that tax unless a waiver is issued by the tax authorities. In a few countries, the possibility exists for a taxpayer to apply in advance for such a waiver. However, tax authorities would need to be convinced that the service provider is not going to exceed the relevant time or other threshold provided in the treaty.

It is recognized that, rather than providing an upfront exemption, a country may impose tax in accordance with its domestic law and subsequently refund any tax that exceeds the amount permitted under the treaty. Countries that follow this latter approach should ensure that they have in place procedures that will allow the refund to be made without any undue delay.<sup>69</sup>

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<sup>69</sup>Ibid.

## Chapter VII

### Taxation of investment income and capital gains

JAN J.P. DE GOEDE\*

#### 1. Introduction

This chapter will focus on both the domestic and tax treaty notions of investment income (namely, income from immovable property, dividends, interest and royalties) and capital gains. Attention will also be paid to some specific issues, including hybrid financing and thin capitalization. Furthermore, the administrative procedures for granting tax treaty benefits with respect to the aforesaid different types of income will be discussed. To this end, this chapter will consider the allocation of taxing rights over these items of income and gains under the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>1</sup> (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>2</sup> (OECD Model Convention)<sup>3</sup>. With respect to the treaty benefits, the main focus will be on the procedures for the granting of these benefits in the source State, but aspects of double taxation relief in the State of residence of the taxpayer will also be briefly dealt with. Only limited attention will be paid to treaty entitlement and anti-abuse issues, as these aspects are extensively

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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

<sup>2</sup>Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital*, (Paris: OECD, 2010) (loose-leaf).

<sup>3</sup>Any references to the United Nations Model Convention and Commentary are to the 2011 version, unless otherwise noted. Similarly, any references to the OECD Model Convention and Commentary are to the 2010 version, unless otherwise noted.

covered in other chapters in this Handbook.<sup>4</sup> Finally, some specific aspects of enforcement will be dealt with.

## **2. Relevant aspects of domestic law and tax treaties**

### **2.1 General legal and administrative framework**

As mentioned in the introductory chapter of this Handbook,<sup>5</sup> there is great diversity amongst countries on how the relationship between tax treaties and domestic law is regarded and whether additional legislation is required to give effect to tax treaties.

Generally, tax treaties are given supremacy over domestic law,<sup>6</sup> leaving aside incidental cases of treaty override.

The absence of more specific legislative rules or administrative procedures and guidance may create serious obstacles to taxpayers to effectively enjoy the tax treaty benefits and, thus, may jeopardize the aim of concluding tax treaties. According to the general tax doctrine followed by most countries, tax treaties do not create new domestic taxing rights,<sup>7</sup> but can limit the application of existing domestic tax law. They also do not contain rules on how taxes are levied. In view of that, it is necessary to provide a general overview, first, of the various domestic tax laws to see whether, and, if so, how, the types of income and gains dealt with in this chapter are defined and, second, of how the tax on these items of income and gains is levied. Finally, the effect of tax treaty application is briefly dealt with.

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<sup>4</sup>See chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler, and chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

<sup>5</sup>See chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold.

<sup>6</sup>See Articles 26 and 27 of the Convention on the Law of Treaties, Vienna, 23 May 1969.

<sup>7</sup>It should be noted, however, that France has “enabling clauses” in its domestic tax law (for example, Article 165-bis of the Code général des impôts), which provide that if certain taxing rights are allocated to France under a tax treaty, they are also considered to exist under domestic tax law, so that the tax can be effectively levied in accordance with the treaty.

## 2.2 Domestic definition and source of investment income and capital gains

As there are no generally internationally applicable standards for taxation, the definitions of these types of income differ to a large extent in the various countries. They may even differ between various types of law and between different tax laws within each country. In this chapter, the focus will be on the main aspects of the definitions as generally used in income and corporate tax (or specific related withholding tax) laws.

### 2.2.1 Income from immovable property

Generally, a rather broad notion of immovable property is used. It may cover not only tangible property like land, houses, office buildings, factories, but also certain intangible rights vested on immovable property, like usufruct,<sup>8</sup> rights to explore or to exploit certain natural resources, or loans secured by mortgage. Also, the notion of income may be broad, covering income from any form of exploitation, like letting, leasing, or even time-sharing.<sup>9</sup>

### 2.2.2 Dividends

A wide range of definitions of dividends is found in domestic tax laws. Generally, the definition covers formal distributions of profits by companies, as regulated in company law, based on shareholding. However, distributions of profits by other entities based on participation in such entities, or payments on the basis of other rights to profits of a company or of an entity, may also be covered. Dividends covered may include both payments in cash or in kind. Moreover, informal

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<sup>8</sup>A term developed in civil law countries to indicate a right whereby a person may use a certain property and take all the advantages and income therefrom, even though the property is legally owned by another person, subject to the condition that the holder does not change, damage or sell the property. See *IBFD International Tax Glossary*, Julie Rogers-Glabush, ed. (Amsterdam: IBFD, 2009).

<sup>9</sup>For instance, time-sharing is where a person, who owns shares in a company that holds immovable property, receives an entitlement to use (part of) the immovable property during a certain period of time (depending on the number of shares held) instead of receiving a dividend in cash.

distributions (such as benefits granted by a company to its shareholders in the form of products delivered at a rebate, or even for free) may be covered. Furthermore, payments on profit-sharing bonds may be treated as dividends for tax purposes. Finally, in several countries, payments regarding so-called hybrid forms of financing, or interest paid in the case of excessive loan financing (under so-called thin capitalization legislation), may be treated as dividends.<sup>10</sup>

### **2.2.3 Interest**

As regards interest, less diversity seems to exist as most tax legislation seems to define this as income from all types of debt claims. The definition of interest may cover more than just formal payments of interest. For instance, in the case of debt issued below par value, the difference between the amount actually lent out and the amount received at the time of redemption of the debt claim may fall within the scope of this definition. Generally, it also comprises premiums and prizes attached to debt claims. However, differences may exist among countries as to whether the definition of interest also covers income from profit-sharing bonds, hybrid forms of financing, excessive financing, or excessive interest<sup>11</sup> paid to a related lender (which interest, sometimes, may be treated as a dividend). Finally, there may also be differences in the treatment of guarantee fees received on loans provided.

### **2.2.4 Royalties**

Generally, the definition of royalties covers any payments for the use of intellectual property rights as defined in intellectual property law, like copyrights, patents, trade marks etc., as well as for the use of know-how. However, some countries also treat payments for the sale

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<sup>10</sup>These situations are briefly dealt with *infra*, in section 2.3.

<sup>11</sup>Generally speaking, an interest payment between related companies might be considered excessive when the amount of the interest payment exceeds the amount which independent parties would have agreed to. For instance, if an interest rate of 10 per cent was charged, whereas independent parties would only have agreed to a rate of 8 per cent, an amount corresponding to a rate of 2 per cent of the interest payment would be considered as excessive.

of such rights as royalties. Moreover, the borderline between use and sale is sometimes drawn differently. Different approaches also exist as to whether or not payments for the use of films and tapes, or for the leasing of various types of equipment, are included in the definition of royalties. The treatment of payments for software may also differ to a certain extent among countries. Excessive payments of royalties to a related company may not be considered as royalties and are sometimes treated as a dividend.

### **2.2.5 Capital gains**

With respect to capital gains, the tax treatment varies to a large extent among countries, that is to say from taxing none, to taxing some or even all gains. If taxable, such gains may either fall within the scope of general taxes on income, or be levied in the form of a separate tax. Also, within one country, differences in treatment of capital gains may exist among the various types of taxes. For instance, some countries do not levy a capital gains tax on individuals, unless the property alienated was part of a business. Moreover, whereas some countries levy a tax on capital gains derived by a non-resident company selling shares in a company that is a resident of their country, other countries do not tax capital gains in that situation at all, or only if the non-resident shareholder held a substantial interest in the company. Finally, some countries exempt such gains in intercompany situations.

Where defined, these gains generally include those derived from the alienation of (certain types of) assets. However, they may also include deemed gains, which are considered as realized for tax purposes, in the case of other forms of transfer of ownership, such as in case of gift or death, or transfer of assets across the border to another country. They may also include unrealized book revaluations.

### **2.2.6 Source of income or gains**

For the purposes of domestic taxation of cross-border investment income and capital gains, it is generally critical to identify in which country the income is considered to have its source. In the case of income from immovable property, that will generally be the country where the property is located, although several countries may

also consider the country from where rental payments are made as the place of source, whereas others may also consider the income to have its source where the rental contract was signed. Technically more complex issues may arise in the case of intangible property, like certain rights and shares, as the place where they are located may be less clear. In the case of dividends, the source is generally in the country where the company or other entity making the distribution is established, although also the country from where the payment of dividend is made may consider it to have its source there. In the case of interest and royalties, the source will generally be in the country in which the payer is a resident, but under some domestic legislations other criteria may apply, such as the place where the contract was signed, or where the money or intellectual property was used. In the case of capital gains, the source is generally identified in the country where the property is located, whereas different approaches may exist regarding the location of intangible rights like shares. Moreover, the place where the contract is signed may be considered as the place of source.

## **2.3 Hybrid financing and thin capitalization**

Hybrid financing relates to forms of financing which have characteristics both of a loan and of equity capital. Hybrid financing may be used for valid economic reasons, for instance, in the financial sector in view of capitalization requirements. However, it is also frequently used in tax planning in order to realize tax savings by exploiting a different classification of the financing in the countries involved. Thus, a hybrid loan may be recognized as a loan in the country of the debtor, allowing for deductibility of the interest paid on it, whereas in the country of the creditor it may, under a substantive determination, be considered as equity capital. The creditor country may then consider the “interest” received as dividends, which — in intercompany situations — may be tax exempt under a participation exemption regime. Countries may use various criteria (alone or in combination) to determine whether a formal loan is considered hybrid and should be re-classified as equity capital.<sup>12</sup> Some countries which re-classify a formal loan into equity

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<sup>12</sup>These may include:

- interest payable depends on the profitability of the debtor;
- no repayment, or a very long repayment schedule;
- subordination of repayment to claims of other creditors.

capital subsequently treat the interest paid by the debtor as a dividend, on which the withholding tax on dividends may be applied.

Thin capitalization relates to excessive debt financing of a company or other entity. In the case of thin capitalization legislation, the interest paid on debt claims (real loans), is no longer tax deductible insofar as the debt exceeds a certain ratio between debt and equity capital.<sup>13</sup> In addition, in this case the source country may re-classify the non-deductible interest into dividends on which a dividend (withholding) tax may apply.

## **2.4 Ways of assessment and enforcement of the taxes**

The modalities through which taxes are levied on different types of investment income, as well as on capital gains, vary to a large extent among countries. These different ways of levying taxes under domestic law have an impact on how to apply tax treaties.

### **2.4.1 Withholding tax**

Source States generally impose taxation on dividends, interest and royalties derived from their country by non-resident taxpayers by means of obliging the payer of the income to withhold tax at a certain percentage from the gross amount of the payment.<sup>14</sup> Domestic legislation may often contain different rates for different kinds of income. Sometimes, there are (temporarily) reduced rates or even exemptions to promote foreign investment, or the granting of foreign loans or licenses. Such systems are relatively easy to administer by the withholding agents and the tax inspectors competent for them, and are

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<sup>13</sup>Generally, such legislation is only applicable in cross-border situations between related companies or other related entities, as it is aimed at combating erosion of the tax base in the source country by very large (tax deductible) payments of interest to related non-resident companies, which are not subject to tax on that income, or are subject to a substantially lower tax, in their countries, as compared to the tax applicable in the source country.

<sup>14</sup>The payer, or withholding agent, is then obliged to transfer the tax withheld to the appropriate tax authority. Generally, no tax return needs to be filed by the taxpayer and the tax withheld represents a final tax due in that country.

very useful in the enforcement of such taxation, as the payer (generally speaking the withholding agent who is responsible for withholding the tax) usually does not want to run the risk of having to pay taxes and fines if no, or insufficient, tax is withheld. Thus, only limited fiscal intelligence efforts may need to be undertaken to discover tax evasion.

#### **2.4.2 Taxation by assessment**

In the case of income from immovable property and capital gains, however, tax is often levied by means of assessment (albeit in the case of cross-border payment of rent, tax legislation may often provide for a withholding tax to be withheld by the payer of the rent).

The reasons for levying the tax by assessment may be that the income or gain is taxable on a net basis (so the taxpayer is enabled to take certain deductions into account when reporting such income), or because there is not necessarily a cash flow from the source State to the other State and thus no resident payer to withhold tax.<sup>15</sup>

In levying taxes by assessment, two systems should be distinguished: self-assessment, and assessment by the tax authorities.<sup>16</sup> This distinction can also affect the way in which the provisions of tax treaties apply.

Obviously, when levying tax by assessment, proper enforcement is more difficult, as no third party is obliged to report and withhold the tax and, thus, the tax authorities have to rely on the proper disclosure and reporting of the income by the non-resident taxpayer. As a result, probably more fiscal intelligence is needed to avoid tax fraud. Obviously, such intelligence is much more difficult if the income is

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<sup>15</sup>This latter case, for instance, may occur when a non-resident owns a holiday home in the source country, which is rented out to another non-resident, so that the cash flow fully takes place outside the source State.

<sup>16</sup>Under self-assessment, the taxpayer files the tax return in which all deductions and benefits are taken into account, and then pays the tax due. In this system the tax assessment is final, unless the tax authorities upon audit make a re-assessment. Under assessment by the tax authorities, the taxpayer first files a tax return and the tax authorities then make the assessment after having judged the correctness of the return.

received by a non-resident taxpayer from another non-resident, as there is no pay trail, or deduction as costs, by the payer visible in the source State. The source State, as well as the State of residence where the income may not have been reported, thus, need a sufficient legal basis and resources to do audits and investigations.<sup>17</sup>

## **2.5 Effect of tax treaties and their application**

As mentioned in section 2.1, it is assumed that the provisions of tax treaties will generally prevail over the provisions of domestic law,<sup>18</sup> and that they generally do not create new taxing rights for a country.<sup>19</sup>

In order to further understand the effect of tax treaties, it is critical to realize that, in tax treaties, taxing rights on each of the items of income and gains dealt with are allocated either exclusively to one country or are shared between the two countries. In the latter case, either a limited or an unlimited right to tax the income and gains may be granted to the source country, whereas the residence country may also tax the income but must provide relief of double taxation. This means that the domestic taxing rights may be limited by the allocation of taxing rights under the treaty. Furthermore, it means that taxing rights, which do not exist in the country's domestic law and, thus, generally cannot be exercised by it, may be allocated by a tax treaty to that country.

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<sup>17</sup>It is beyond the scope of this chapter to expand on such issues, as these are basically not different from purely domestic situations, albeit the challenges might be much bigger, especially if both the payer and the recipient are non-resident. To address this issue, some countries have not only imposed a reporting obligation on all recipients of taxable income, but also a withholding obligation on non-resident payers of the income (for instance, in the case of sale of shares of a company resident in the source State, on the non-resident buyer who made a payment to a non-resident seller). Obviously, the enforcement of reporting requirements or withholding obligations on a non-resident is more complex, especially for developing countries which generally have fewer resources to assure such enforcement.

<sup>18</sup>Either directly or via incorporation of the tax treaty in the domestic legal system.

<sup>19</sup>See, however, footnote 7.

Besides the allocation provisions, other provisions are included in tax treaties, such as those on non-discrimination, which are mentioned in the introductory chapter of this Handbook<sup>20</sup> and which will not be discussed further in this chapter.<sup>21</sup>

Against the above-mentioned background, the following aspects are of importance when applying a tax treaty:

- How are the taxing rights allocated for each type of income and gains and how are the latter defined?
- Who is allowed to claim the treaty benefits?
- How can it be assured that the treaty is properly applied so that a taxpayer can realize the benefits of either a lower taxation in the source State, or of relief from double taxation in the residence State as foreseen in the tax treaty?

Before addressing these aspects in the following sections, it is useful to comment briefly on those cases where a tax treaty allocates a taxing right to a country, which does not (yet) have such a right under its domestic tax law. As tax treaties are generally considered not to create new domestic taxing rights, such right can then not be exercised by the relevant country. Thus, if a tax treaty allocated the right to a country to levy a tax of 10 per cent on the gross amount of interest paid to the resident of the other country, and the source country did not impose such taxation under its domestic law, generally speaking the source country could not levy such tax.<sup>22</sup> This aspect might, or should have, played a role during the tax treaty negotiations.

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<sup>20</sup>See chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold.

<sup>21</sup>In the case where taxing rights have been allocated to countries under tax treaties, which allow them to fully tax the income in accordance with their domestic law, it should be borne in mind that this does not mean that they would not have to respect any relevant non-discrimination provision included in the relevant treaty.

<sup>22</sup>See, however, footnote 7.

### **3. Treaty allocation of taxing rights and treaty definitions with respect to investment income and capital gains**

#### **3.1 General aspects**

In the following sections, the allocation of taxing rights over investment income and capital gains, as well as how these items of income and gains are defined in tax treaties, will be considered. It is important to understand that such definitions or classifications only apply for the purposes of the allocation of taxing rights under tax treaties and have no direct bearing on the classification of such income or gains under domestic law, or on the system of levying taxes under domestic law. For treaty allocation purposes, only the treaty definition is decisive, unless it also refers to domestic law, or contains terms not defined in the treaty. In this last case, under Article 3 (2) of both the United Nations and OECD Model Conventions, the terms have to be interpreted on the basis of domestic law, unless the treaty context otherwise requires.

Finally, situations such as those in which the two contacting States classify the income differently for treaty purposes will be briefly considered; these are referred to as “conflicts of qualification” in the Commentaries to the OECD Model Convention.

#### **3.2 Income from immovable property**

According to Article 6 (1) of both the United Nations and OECD Model Conventions, income from immovable property derived by a resident of one country from immovable property situated in the other country, may be fully taxed in the country where the immovable property is situated in accordance with its tax legislation. In that case, the country of residence of the recipient of the income may also fully tax such income, but must then provide relief for the tax levied in the source country, under Article 23 of both the United Nations and OECD Model Conventions.

The definition of immovable property included in Article 6 (2) of both the United Nations and OECD Model Conventions is identical, and refers for the meaning of immovable property to the laws of the country in which the property is situated. The definition, however, also

explicitly includes accessory property, as well as livestock and equipment used in agriculture and forestry, and several other rights, including usufruct on immovable property and rights to payments regarding the working of, or the right to work, mineral deposits, and, finally, excludes ships, boats and aircraft. Despite the reference to domestic law of the source country, artificial deeming provisions might probably still be challenged under the general treaty principle of “good faith”, as provided under Article 26 of the Vienna Convention on the Law of Treaties.<sup>23</sup>

It is mentioned<sup>24</sup> that no provisions are included in Article 6 of both the United Nations and OECD Model Conventions on income from debt claims secured by mortgage; as such income is classified as interest under Article 11 of these Model Conventions.

Article 6 (3) of both the aforesaid Model Conventions also makes clear that the term income is to be interpreted broadly, covering income from the direct use, letting, or use in any form of immovable property.

As the definition of income from immovable property is very broad and there are no limitations in the treaty as regards the level of taxation in the source country (nor with respect to either taxation of such income on a net or on a gross basis), this provision will probably rarely lead to a limitation of the taxing rights of the source country and, thus, generally not require specific arrangements for the taxpayer to be able to claim specific treaty benefits.<sup>25</sup>

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<sup>23</sup>See *supra* footnote 6.

<sup>24</sup>Paragraph 7 of the Commentary on Article 6 of the United Nations Model Convention and paragraph 2 of the Commentary on Article 6 of the OECD Model Convention.

<sup>25</sup>For the sake of completeness, reference is made to paragraph 4 of the Commentary on Article 6 of the United Nations Model Convention, where the specific situation of time-sharing is briefly discussed and to paragraph 3 of the Commentary on Article 6 of the OECD Model Convention, which deals with the specific situation of Real Estate Investment Trusts (REITs).

### 3.3 Dividends

Under Article 10 of both the United Nations and OECD Model Conventions, the taxing right on dividends paid by a company resident in one country<sup>26</sup> to a resident of the other country is shared in the sense that the former country may levy a tax on such dividends, which is limited to a certain percentage of the gross amount of the dividends if the beneficial owner<sup>27</sup> is a resident of the other country, whereas the latter country is also allowed to tax the dividends but must provide relief of double taxation. In the OECD Model Convention the tax of the country of source is limited to a maximum of 5 per cent of the gross amount of the dividends for qualifying participations, and to 15 per cent of the gross amount for portfolio participations. In the United Nations Model Convention, the percentages are left open to be established during the bilateral negotiations.

It should be noted that the threshold of participation required to be able to benefit from the lower rate for qualifying participations is lower in the United Nations Model Convention than in the OECD Model Convention (respectively, 10 per cent and 25 per cent of the capital of the company paying the dividends).

Finally, under Article 10 (4) of both the United Nations and OECD Model Conventions, there is no limitation of the taxing rights of the source country, in case the dividends paid are attributable to a permanent establishment<sup>28</sup> that an enterprise, which is resident in the other country, maintains in the source country.<sup>29</sup> In such cases, the source country is allowed to fully tax the dividends as part of the

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<sup>26</sup>Thus, the country of source of the dividends is determined in the treaty.

<sup>27</sup>On the notion of beneficial owner, see chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler, and chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

<sup>28</sup>This is the case if the holding in respect of which the dividends are paid is effectively connected with such permanent establishment.

<sup>29</sup>Article 10 (4) of the United Nations Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of this Model Convention (not included in the OECD Model Convention) and the dividends received are attributable to a fixed base maintained by that person in the source country.

profits of the permanent establishment under Article 7. As there is no treaty benefit regarding the taxation of the dividends in the source country, this matter will not be further considered.

In all of these cases, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief, under Article 23 of both the United Nations and OECD Model Conventions, for the tax levied in the source country.

The definition of dividends as provided in Article 10 (3) of both the United Nations and OECD Model Conventions is identical. It lists the income from the most commonly used types of shares, and other rights, not being debt claims, participating in the profits, and ends with an open formula that also includes income from other corporate rights which is treated the same as income from shares by the laws of the country in which the company making the distributions is a resident. Thus, the definition is open ended, and it generally covers the distributions of profits by limited liability companies and also, in many countries, such distributions by co-operative societies. It can equally cover distributions by non-transparent partnerships subject to the same taxation on the profits as companies, but not income from debt claims participating in the profits, nor income from convertible debentures.<sup>30</sup> Furthermore it is clarified<sup>31</sup> that the notion of dividends not only covers dividends decided by the general meeting of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on liquidation, and disguised distribution of profits. Finally, it is also clarified<sup>32</sup> that dividends as meant in this Article also include interest on loans insofar as the lender effectively shares the risks run by the company. Thus, Articles 10 and 11 do not prevent such interest to be treated as dividends under domestic thin capitalization rules. It is also clarified that whether the lender shares

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<sup>30</sup>Paragraph 14 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraphs 24, 26 and 27 of the Commentary on Article 10 of the OECD Model Convention.

<sup>31</sup>Paragraph 14 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 28 of the Commentary on Article 10 of the OECD Model Convention.

<sup>32</sup>Paragraph 14 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 25 of the Commentary on Article 10 of the OECD Model Convention.

the risks of the company must be determined in each individual case in the light of all the circumstances, including the following:

- The loan very heavily outweighs any other contribution to the capital and is substantially unmatched by redeemable assets
- The creditor will share in any profits of the company
- Repayment is subordinated to other creditors or to payments of dividends
- The level of interest depends on the profits
- There are no fixed provisions in the loan contract for repayment by a definite date.

This clarifies the treatment of interest as dividends for tax treaty purposes in the case of hybrid financing and of thin capitalization legislations mentioned in section 2.3.

Due to this broad, open treaty definition of dividends, domestic definitions of treaty countries will almost always be covered under the treaty definition. There could be, however, very specific cases where careful interpretation has to take into account the object and purpose of the treaty. A common element in the discussion on the treaty notion of dividends in the Commentary on Article 10 (3) of both the United Nations and OECD Model Conventions seems to be that there should be a distribution of income by the company or other entity covered. That would seem to imply that, for instance, the gain derived from the sale of shares by a shareholder would generally not be covered by Article 10, but by Article 13, even though the source country treated it as a dividend under its domestic law, as there is an alienation of the shares in the company covered by Article 13, and not a distribution of income by the company.<sup>33</sup>

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<sup>33</sup>This might perhaps be different where, as part of a set of artificial transactions, the main purpose of which would be benefiting from a more favorable tax treatment by transforming dividends into a capital gain, such capital gain could be re-classified as dividends for domestic law purposes (for example, under a general anti-abuse provision, such as substance over form). Then, this re-classification might also occur for treaty purposes, if the circumstances were such that the more favorable treatment as capital gain would be contrary to the object and purpose of the relevant treaty provisions.

In the case of dividends, generally speaking, there is a need to make arrangements for taxpayers to be able to claim the treaty benefits, as the amount of tax which the treaty allows to be levied on the dividends in the source country (mostly levied via a withholding tax system) may be lower than the amount of tax due on the dividends under its domestic law, whereas it should also be established whether the treaty requirements for the entitlement to such reduction of tax (for instance, beneficial ownership and, where relevant, the participation threshold) are met. Such procedures are dealt with in section 4.4.

### 3.4 Interest

Under Article 11 (1) and (2) of both the United Nations and OECD Model Conventions, the taxing right on interest arising in one country and paid to a resident of the other country is shared — in the sense that the former country may levy a tax on such interest, which is limited to a certain percentage of the gross amount of the interest if the beneficial owner is a resident of the other country — whereas the latter country may also tax the interest but must provide relief of double taxation. In the OECD Model Convention the tax is limited to 10 per cent of the gross amount of the interest, whereas in the United Nations Model Convention the percentage is left open to be established during the bilateral negotiations.

According to Article 11 (5) of both Model Conventions, interest is, for treaty purposes, deemed to arise in a country if it is paid by a resident of that country, or if it is borne by a permanent establishment maintained in that country by a resident of the other country.<sup>34</sup> Thus, as in the case of dividends, the country of source of the interest income is defined in the tax treaty.

Finally, under Article 11 (4) of both Model Conventions, there is no limitation of the taxing rights of the source country, if the interest

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<sup>34</sup>Article 11 (5) of the United Nations Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the interest received is attributable to a fixed base maintained by that person in the source country.

paid is attributable to a permanent establishment<sup>35</sup> that an enterprise resident in the other country maintains in the source country.<sup>36</sup> In such cases, the source country is allowed to fully tax the interest as part of the profits of the permanent establishment. As there is no treaty benefit to be granted regarding the taxation of the interest in the source country, this matter will not be further discussed.

In all of the cases where the source country is allowed to tax the income, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief under Article 23 of both Model Conventions for the tax levied in the source country.

The definition of interest in Article 11 (3) of both the United Nations and OECD Model Conventions is identical. In this case, it is a closed (or exhaustive) treaty definition, which does not refer to domestic law. The core elements of the definition are as follows: income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the profits of the debtor, income from government securities, bonds, and debentures, including premiums and prizes attaching to such securities. It is also explicitly mentioned that penalty charges for late payments are not regarded as interest. It is clarified that such closed-definition of interest was considered possible as it practically covers all the types of income regarded as interest in the domestic laws of countries.<sup>37</sup> It is also mentioned<sup>38</sup> that payments made under non-traditional financial

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<sup>35</sup>This is the case if the debt claim in respect of which the interest is paid is effectively connected with such a permanent establishment

<sup>36</sup>Article 11 (4) of the United Nations Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the interest received is attributable to a fixed base maintained by that person in the source country. It also allows for taxation of the interest as part of the profits of a permanent establishment in case the interest is attributable to it under Article 7 (1) (c) of that Model Convention.

<sup>37</sup>Paragraph 19 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 21 of the Commentary on Article 11 of the OECD Model Convention.

<sup>38</sup>Paragraph 19 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 21.1 of the Commentary on Article 11 of the OECD Model Convention.

instruments where there is no underlying debt (such as various types of interest rate swaps) are generally not considered as interest, unless a loan is deemed to exist under an anti-abuse provision, such as substance over form or a similar doctrine.<sup>39</sup> Furthermore, it is clarified that the definition applies to Islamic financial instruments where the economic reality of the contract underlying the instrument is a loan (even if the legal form thereof is not).<sup>40</sup>

In addition, it should also be noted that in both the United Nations and OECD Model Conventions a provision (Article 11 (6)) has been included, which makes clear that in the case of a special relationship between the beneficial owner and the payer or between both of them and some other person, the provisions of this Article only apply to the part of the interest which would have been agreed upon had they dealt with each other on an arm's length basis. For the notion of special relationship, reference is made in both the United Nations and OECD Commentaries<sup>41</sup> to Article 9, Associated enterprises. As regards the classification of the excessive part of the payment for domestic and treaty purposes, all relevant circumstances must be taken into account.<sup>42</sup> For instance, if the payment was made by a company to its shareholder, the excessive amount may perhaps be treated

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<sup>39</sup>For a discussion of approaches used by countries to address the improper use of treaties, including the substance over form and other judicial doctrines, see the Commentary on Article 1 of the United Nations Model Convention. See also chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Philip Baker.

<sup>40</sup>Reference is made to paragraph 19.2 of the Commentary on Article 11 of the United Nations Model Convention, where a number of such instruments has been mentioned.

<sup>41</sup>Paragraph 22 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraphs 33 and 34 of the Commentary on Article 11 of the OECD Model Convention. Besides the reference to Article 9, it is also mentioned that relationship of blood, or marriage and, in general, any community of interests as distinct from the legal relationship regarding the payment of interest, are covered.

<sup>42</sup>Paragraph 22 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraphs 35 and 36 of the Commentary on Article 11 of the OECD Model Convention.

as a dividend under the domestic tax law of the payer, and thus also as a dividend for tax treaty purposes.<sup>43</sup>

In the context of tax treaty administration and from a practical point of view, it is also important to mention that many treaties provide for different maximum rates of tax, or no tax at all, to be levied in the source country, with respect to different types of interest. This partly relates to the fact that, mainly for practical and enforcement reasons, in most countries the tax on cross-border interest payments is levied via a withholding tax on the gross amount of the interest paid. This might lead to a very high effective tax on creditors if they had incurred considerable expenses to fund the loan.<sup>44</sup> Such high taxation could lead to it being passed on to the debtors in the form of increased interest due on the loans, which would be unfavourable for the business in the source country. In other cases, there are different economic reasons (as in the case of government loans or loans provided by pension funds) to lower the tax treaty rate in order to make it more attractive for the creditors to provide funding to projects in the source country. This topic is described in more details in the Commentaries on both the United Nations and OECD Model Conventions.<sup>45</sup>

If the amount of tax which is allowed to be levied under the treaty in the source country is lower than the amount of tax due (mostly via a withholding tax system) under the domestic law of that country, there will be a need to make arrangements to allow the taxpayers to claim the treaty benefits. These arrangements are also needed in view of the verification of the requirements for the entitlement to the treaty benefits (for instance, beneficial ownership and, where relevant, the type of interest). Such procedures are dealt with in section 4.4.

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<sup>43</sup>This would allow the country of the payer to levy tax up to the maximum percentage, as specified for dividends in the tax treaty, on the gross amount of the excess payment.

<sup>44</sup>Such as in the case of financial institutions.

<sup>45</sup>Paragraphs 11-17 of the Commentary on Article 11 of the United Nations Model Convention and paragraphs 7.1-7.12 of the Commentary on Article 11 of the OECD Model Convention.

### 3.5 Royalties

As described below, there are fundamental differences between the United Nations Model Convention and the OECD Model Convention regarding Article 12, which cause this Article to pose more problems in terms of tax treaty administration than the articles on other types of income mentioned above.

First of all, under Article 12 (1) of the OECD Model Convention, the taxing rights over royalties arising in a treaty country and paid to a resident of the other country, who is the beneficial owner of the income, are exclusively allocated to the residence country of the recipient. Under Article 12 (1) and (2) of the United Nations Model Convention, however, taxing rights are shared between the source country and the residence country of the recipient and the maximum rate of tax allowed to be levied in the source country on the gross amount of the royalties is left open for tax treaty negotiations, as in the case of Articles on dividends and interest.

Under Article 12 (5) of the United Nations Model Convention,<sup>46</sup> royalties are deemed to arise, for treaty purposes, in a country if they are paid by a resident of that country, or if they are borne by a permanent establishment maintained in that country by a resident of the other treaty country. Thus, as in the case of dividends and interest, the country of source of the royalties is determined by the treaty.

Finally, under Article 12 (3) of the OECD Model Convention and Article 12 (4) of the United Nations Model Convention,<sup>47</sup> there is

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<sup>46</sup>Article 12 (5) of the United Nations Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the royalties received are attributable to a fixed base maintained by that person in the source country.

<sup>47</sup>Article 12 (4) of the United Nations Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the royalties received are attributable to a fixed base maintained by that person in the source country. It also allows for taxation of the royalties as part of the profits of a permanent establishment in case the royalties are attributable to it under Article 7 (1) (c) of that Model Convention.

no limitation of the taxing rights of the source country, if the royalties paid are attributable to a permanent establishment<sup>48</sup> that an enterprise resident in the other treaty country maintains in the source country. In such cases, the source country is allowed to fully tax the royalties as part of the profits of the permanent establishment. As there is no treaty benefit to be granted regarding the taxation of the royalties in the source country, this situation will not be further considered.

In all of the cases where the source country is allowed to tax the income, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief in accordance with Article 23 of both the United Nations and OECD Model Conventions for the tax levied in the source country.

Although the larger part of the definition of royalties in both the United Nations and OECD Model Conventions is the same, there are some important differences.<sup>49</sup> The common element in the definition is the coverage of payments of any kind for the use, or right to use, any copyright of literary, artistic or scientific work including cinematographic films (referred to as copyright royalties), any patent, trade mark, design or model, plan, secret formula or process (referred to as industrial royalties), or for information concerning industrial, commercial or scientific experience (frequently referred to as payments for know-how and basically covering undisclosed knowledge and experience).

Under the United Nations Model Convention, however, the definition of royalties includes also the payments for the use, or right to use, films or tapes for radio or television broadcasting, and payments for the use, or right to use, industrial, commercial and scientific equipment (the latter being referred to as payments for leasing).

Besides these very relevant differences between the text of the United Nations and OECD Model Conventions, there are substantial issues of interpretation which are dealt with in a different level of

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<sup>48</sup>This is the case if the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment.

<sup>49</sup>See Article 12 (3) of the United Nations Model Convention and Article 12 (2) of the OECD Model Convention.

detail in the Commentaries to these Model Conventions. Thus, there are considerable chances that the interpretation of the term royalties under treaties deviates from its interpretation under domestic laws.<sup>50</sup>

Finally, it should be noted that in both Model Conventions a provision (Article 12 (6) of the United Nations Model Convention and Article 12 (4) of the OECD Model Convention) has been included which makes clear that in the case of a special relationship between the beneficial owner and the payer, or between both of them and some other person, the provisions of the Article only apply to the part of the royalties which would have been agreed upon had they dealt with each other on an arm's length basis.<sup>51</sup>

Although the definition of royalties is rather broad, there are still considerable chances that the domestic notion and the treaty notion deviate due to the interpretation issues mentioned above. If the amount of tax which is allowed to be levied under the treaty in the source country is lower than the amount of tax due (mostly via a withholding tax system) under the domestic law of that country, there will

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<sup>50</sup>For instance, relevant issues may include:

- the borderline between certain types of rights to use and partial sales (for instance the transfer of rights that constitute a distinct and specific property);
- the borderline between royalties and fees for technical services and also mixed contracts (some treaties include provisions on technical services in the article on royalties or include a separate article on these services);
- the borderline between use of know-how, services and rental income in the context of satellites and other means of communication;
- the borderline between royalties and rights to distribute products and services;
- the specific aspects of the use and transfer of various types of software;
- the classification of payments in the context of e-commerce;
- the provision of different rates for different types of royalties.

For a comprehensive discussion of these issues, see the Commentaries on Article 12 (3) of the United Nations Model Convention and on Article 12 (2) of the OECD Model Convention.

<sup>51</sup>See *supra* section 3.4, where a similar situation has been discussed with respect to interest.

be a need to make arrangements to allow the taxpayers to claim the treaty benefits. These arrangements may also be needed in view of the verification of the requirements for entitlement to the treaty benefits (for instance, beneficial ownership and, where relevant, the different types of royalties). Such procedures are dealt with in section 4.4 below.

### 3.6 Capital gains

Article 13 as included in both the United Nations and OECD Model Conventions contains several special features, including:

- There is no definition of capital gains in either the United Nations or the OECD Model Conventions, due to the great diversity in taxing such gains between the domestic tax laws of the countries.
- Capital gains related to quite different types of assets are covered.
- There are major differences between the aforesaid Model Conventions in the allocation of taxing rights regarding gains on the sale of shares.
- For some gains, the allocation of taxing rights is shared between the source and the residence country; in such cases, however, there is no limitation on the taxation in the source country. For other gains, there is an exclusive taxing right allocated to the residence country.
- Taxes on these gains are usually levied on a net basis (proceeds minus purchase price or book value) and, therefore, mostly by assessment, which may lead to additional enforcement issues.

Although there is no definition of capital gains in both the United Nations and OECD Model Conventions, the Commentaries thereto clarify what the scope of this notion may be<sup>52</sup>. Capital gains may thus include gains made in the context of alienation or other transfers of ownership, as in the case of gifts or death, but also in cases of emigration of the owner and/or the assets, and, in some countries, also in case of revaluations of book values.

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<sup>52</sup>Paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraphs 5-11 of the Commentary on Article 13 of the OECD Model Convention.

Article 13 (1), (2) and (3) of both the United Nations and OECD Model Conventions deal respectively with cross-border gains on directly held immovable property, assets belonging to a permanent establishment in the other country, and ships and aircraft operated in international traffic and boats used in inland waterways transport, including movable property pertaining to the operation by such means of transport. The allocation of the taxing rights follows the same allocation as the income from such activities as provided in Articles 6, 7, and 8, respectively. If tax is levied, that is usually done via assessment, with the consequent enforcement problems of being informed of the transactions and securing that the tax due can be effectively levied.

Article 13 (4) of both the United Nations and OECD Model Conventions deals with capital gains which a resident of a country derives from the indirect sale of immovable property<sup>53</sup> situated in the other treaty country, via the alienation of the shares in a company (or, in the case of the United Nations Model Convention, also interests in other entities) that owns the property, provided that more than 50 per cent of the value of such shares (or, in the case of the United Nations Model Convention, the value of the assets owned by such company or entity) is derived directly or indirectly from such immovable property. In such a case, the country where the immovable property is situated may tax the gains on the sale of the shares, without limitation. The provision is intended to make it impossible to avoid source taxation, as provided for under Article 13 (1), by holding the immovable property situated in the other country indirectly via a company or other entity and by subsequently alienating the shares or other participations instead of the immovable property itself<sup>54</sup>. The tax is usually levied by

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<sup>53</sup>For the definition of immovable property, reference is made to Article 6 (2) of both the United Nations and OECD Model Conventions. This notion may also include certain types of rights considered as immovable property in the country concerned (see also *supra* sections 2.2.1 and 3.2).

<sup>54</sup>Meanwhile, however, issues of interpretation and of avoidance of the application of Article 13 (4) of the United Nations Model Convention have been identified, which will be addressed by the Committee of Experts on International Cooperation in Tax Matters. With respect to avoidance issues, if artificial transactions have been undertaken (such as certain structuring of the sale of shares, or temporary cash contributions to the company or other entity meant to stay below the 50 per cent threshold), the main purpose of

assessment on the net amount of the gain. The tax may be difficult to enforce in the source country, in particular if the company or entity is a resident of the other country, or if the seller or buyer is not a resident of the source country, or in the case of sale of shares or participations in companies or other entities that, in turn, own directly or indirectly, through a corporate chain, the company or entity which owns the immovable property. If the buyer is a resident of the source country it may be easier to find information helpful to secure the enforcement of the taxation on the seller, but, in the case of a non-resident buyer, reporting requirements or withholding obligations imposed in respect of the gains may be difficult to enforce.

Article 13 (5) of the United Nations Model Convention also allocates an unlimited taxing right to the source country in the case of the alienation by a resident of the other treaty country of shares directly held in a company resident in the source country. It only applies if the shareholder held directly or indirectly at least a certain percentage (to be determined in the negotiations) of the shares in the company, at any time during the twelve-month period preceding the alienation of the shares. The tax is usually levied by assessment on the net amount of the gain, and is similarly difficult to enforce in the source country.

In all other cases of capital gains realized by a resident of a treaty country, both the United Nations and OECD Model Conventions allocate an exclusive taxing right to that country (that is to say, the country of residence of the person who realizes the gains).

In the cases where the provisions of Article 13 lead to an unlimited source-State taxing right, there seems to be no reason for the source country to introduce specific arrangements for the taxpayer to be able to claim specific treaty benefits, as the source country will generally be able to fully apply its domestic law.<sup>55</sup> This is different from the

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which would be to avoid the application of the provision, such avoidance may be combated under a general anti-abuse provision included in the domestic law if this were in circumstances where such avoidance would be contrary to the object and purpose of the treaty provision (see the Commentaries on Article 1 of the United Nations Model Convention regarding the application of such domestic anti-avoidance measures).

<sup>55</sup> Assuming that a tax liability exists in these situations in that country under its domestic law, which may not always be the case.

cases where the source country has a taxing right under its domestic law, but the treaty allocates an exclusive taxing right to the country of residence (as, for example, in the case of the sale of shares not covered by the provisions discussed above). In such cases, there may be a need for arrangements to secure treaty benefits for the taxpayer. These arrangements are dealt with in section 4.5.

### **3.7 Qualification issues**

As described above, in several cases the treaty definitions of the various types of income refer back to domestic law, and where the domestic definition deviates between the two treaty countries, this may lead to the application by these countries of different articles of the treaty. If this is caused by the application of the domestic law, this is referred to as a conflict of qualification in the Commentaries to the OECD Model Convention.

For instance, if a parent company receives a liquidation payment due to the liquidation of its subsidiary in the other country, such payment may be treated on the basis of the domestic law of the source country as a dividend (entitling that country to levy tax on that dividend up to the percentage included in Article 10 of the treaty), whereas it may be treated as a capital gain under the domestic law of the residence country (exclusively taxable in that country if not covered under a provision like Article 13 (4) of the United Nations and the OECD Model Conventions, or like Article 13 (5) of the United Nations Model Convention). Therefore, these conflicts of qualification may cause double taxation as the source country would levy the tax allowed under Article 10, whereas the country of residence would not provide relief for that tax. In the Commentary on Article 23 of the OECD Model Convention,<sup>56</sup> the view is taken that if the conflict only arises as a consequence of applying the different domestic laws, but the source country applies the treaty correctly to that income (in the example mentioned above, by not taxing the dividends at any higher rate than that allowed under Article 10), the country of residence should then grant relief as the source country levied the tax in accordance

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<sup>56</sup>Paragraphs 32.1-32.7 of the Commentary on Article 23 of the OECD Model Convention.

with the treaty.<sup>57</sup> It should be mentioned that conflicts of qualification have not been discussed by the United Nations Committee of Experts on International Cooperation in Tax Matters yet and, thus, the Commentaries to the United Nations Model Convention take no position with respect to this interpretative issue.

Finally, it should be mentioned that the interpretation of the OECD only applies to those conflicts which arise from the application of domestic law, and not if they occur because of a different interpretation of the facts or of the treaty itself. In the latter cases, such problems can only be dealt with under the mutual agreement procedure provided under Article 25 of both the United Nations and OECD Model Conventions. Therefore, if faced with conflicts of qualification, countries which are not members of the OECD, as is the case for almost all developing countries, should consider whether such interpretation is acceptable to them when applying a tax treaty, or otherwise rely on the mutual agreement procedure to solve any relevant problems.

#### **4. Legal framework, administrative procedures for granting treaty benefits to taxpayers, and responsible tax authorities**

##### **4.1 Approach taken — Source and residence State perspective**

Tax treaties are primarily concluded with the aim of avoiding double taxation and, as a result, removing obstacles to the cross-border mobility of persons and investment. This is done to promote the economic development of both countries concerned. It is, therefore, obvious that if tax treaties cannot be properly applied, including the granting of the benefits to those entitled to them, the whole purpose of tax treaties may be jeopardized. On the other hand, tax treaties are also meant to

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<sup>57</sup>On the other hand, in the reverse situation (that is to say, the source country considers the Article on capital gains applicable, while the country of residence considers the Article on dividends applicable), the residence country will not be obliged to give relief, as the source country considered that it was not entitled to tax the income in accordance with the treaty.

prevent tax avoidance and evasion, and the tax benefits included in these treaties should be granted only to those entitled to them.

Several issues need to be dealt with in order to apply tax treaties properly. These issues depend on various aspects of the specific legal structure existing in the countries, as well as on the technical and administrative resources available to the local tax administrations, and finally on the volume of the cross-border income flows, which may influence whether more sophisticated regulations and systems need to be developed, or not.

Tax treaties are virtually silent on the matter of their application and basically leave this aspect to the domestic law of the countries concerned. Only the Articles on dividends, interest and royalties contain provisions on this matter.<sup>58</sup> These Articles state that “the competent authorities of the Contracting States shall by mutual agreement settle the mode of application” of the relevant provisions. However, the Commentaries on these provisions indicate that the source countries are free to apply their domestic law within the limits of the treaty.<sup>59</sup>

It has been pointed out, in international tax literature, that countries do not always make such mutual agreements in practice and that no generally accepted standardized approaches have been developed.<sup>60</sup> Thus, it is not possible to present a generally acceptable and universally applicable approach to deal with all the aspects of the application of tax treaties.

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<sup>58</sup>With respect to dividends, see Article 10 (2) of both the United Nations and OECD Model Conventions; with regard to interest, see Article 11 (2) of both the aforesaid Model Conventions; and with respect to royalties, see Article 12 (2) of the United Nations Model Convention. As the OECD Model Convention allocates an exclusive taxing right to the residence country of the recipient of royalty payments, in the case of royalties it was apparently considered not necessary to include a similar provision.

<sup>59</sup>On this point, see chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold.

<sup>60</sup>See David W. Williams, International Fiscal Association, General Report on “*Practical issues in the application of double taxation conventions*”, Cahiers de droit fiscal international, vol. LXXXIIIb, (Deventer, the Netherlands: Kluwer, 1998).

Therefore, the most feasible approach seems to be describing a kind of general common denominator in the practices which are normally followed by countries,<sup>61</sup> taking also into account some recent developments in this area of treaty application. Thus, the following sections are aimed at providing some further insight into the various issues concerned and making some general recommendations, taking into account the specific nature of the various types of income and gains dealt with in this chapter and how taxes on these income and gains are generally levied and administered.

Although the focus in this chapter is on the application of the treaty in the source country, aspects of treaty application regarding the granting of double taxation relief in the residence country will be briefly discussed as well.<sup>62</sup> The more general legal and administrative aspects, including the organization of the tax administration, will be dealt with in the following section; subsequently, a more detailed analysis of possible approaches regarding the practical application of tax treaties will follow, which will address separately the relevant issues for each type of income and gains considered in this chapter.

#### **4.2 More specific legal framework and aspects regarding the tax administration**

As mentioned previously, it is of great importance that the treaty receives the binding force in the legal system of the countries concerned and, if necessary, legislation dealing with that is introduced before and applicable when it becomes effective.

It is also important to ensure that a sufficient legal basis exists for implementing decrees, regulations, etc. (to be issued by the responsible officials) about the modalities through which treaty benefits can be enjoyed. In this respect, reference can be made to the procedures through which a rate reduction of, or exemption from, the withholding taxes on dividends, interest and royalties can be realized.

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<sup>61</sup>Ibid.

<sup>62</sup>For a comprehensive discussion of the aspects relating to the granting of double taxation relief in the residence country, see chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

Furthermore, it is important for the application of tax treaties that these implementing decrees or regulations include any statutory time limits to the possibility of applying for the benefits or reliefs provided for under the treaty. It is equally useful that such decrees or regulations mention the (local) tax inspectors or entities dealing with the specific treaty application. To this end, it is important to take into account both the types of tax involved and the level of knowledge available in the tax administration, as well as the frequency of treaty application in practice, which may vary considerably amongst countries, depending on the level of international investment and the number of tax treaties applicable.

Also in the area of tax treaty application, the tax administration should have enough legal powers to be able to acquire all relevant information and obtain the cooperation of the taxpayer, in order to judge the validity of the claims for such benefits, as well the powers to properly enforce tax claims or to make additional assessments if it turns out that the taxpayer was not entitled to the specific treaty benefits. On the other hand, it is also important from a taxpayer perspective that any decision regarding the tax relief (at source) or refund of taxes assessed by a tax inspector can be appealed within a certain period to be determined. Although such aspects may have already been included in the existing tax legislation, depending on the circumstances, it may be desirable to include more specific provisions, or to refer to these in the case of specific decrees or regulations regarding treaty application.

As regards the organization of the tax administration, depending on the specific circumstances in the country concerned, it will need to be determined which body is best suitable to deal with these international matters (taking into account the type of taxes, the level of education and language skills of the various tax bodies), and whether a restructuring of the current division of tasks is necessary to be able to properly apply tax treaties. For instance, decisions regarding rate reduction of the withholding tax at source can perhaps be made best by the tax inspector/inspectorate responsible for imposing such taxes, which may be the tax inspectorate responsible for the corporate income tax of the company paying the income, whereas applications for refunds of withholding taxes to non-residents may perhaps be best dealt with by a specific body dealing with the taxation of non-residents.

Under all methods and procedures used, the entitlement to treaty benefits of specific structures (such as partnerships, trusts, collective investment vehicles, pension funds and charities) may pose problems.<sup>63</sup> If not solved in the treaty or in interpretative mutual agreements, as provided under Article 25 of both the United Nations and OECD Model Conventions, these issues will need to be discussed with the competent tax authorities on an ad hoc basis. If solved, such interpretation should be published and included in the relevant decrees, regulations, instructions to forms used, etc. for treaty application.

More detailed remarks on treaty application and enforcement will be made hereafter, separately for each specific category of investment income and capital gains.

### **4.3 Income from immovable property**

In many countries, tax on income from immovable property is levied by way of (self-) assessment<sup>64</sup> and tax treaties generally allocate an unlimited taxing right over income from immovable property to the country where the property is located.<sup>65</sup> Therefore, generally it is not necessary to make any specific arrangement for granting treaty benefits to non-residents in the country where the immovable property is situated.

The main issue seems to be how to find out that a property is owned by a non-resident and whether or not the non-resident earned any income from exploiting it. In this respect, it is important whether a public register exists or not, in which the ownership of immovable property needs to be registered. Furthermore, it is critical that such information is available to the tax administration, in addition to any specific fiscal intelligence measures (such as, searching and reporting

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<sup>63</sup>See chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler.

<sup>64</sup>This income may be taxable on a net income basis (which requires the taxpayer to be able to demonstrate which costs were incurred), or on an imputed income basis (for instance, in the case of owner-occupied holiday homes, where there is no cash flow on which a withholding tax could be levied).

<sup>65</sup>See *supra* section 3.2.

on advertisements in which the immovable property is offered for rent, which may be difficult if the property is rented out to another non-resident).

With respect to the tax inspector or tax administration entity responsible for such taxation, in the case of non-residents a special entity is often designated to deal with these taxpayers.

However, some countries do levy a withholding tax on the gross amount of (cross-border) rental income from immovable property.<sup>66</sup> In such cases, the payer of the rent is required to withhold the tax and pass it on to the designated tax authorities.

As mentioned above, the taxing right regarding income from immovable property is generally allocated to the source country without limitation and, thus, there are generally no treaty benefits available to the non-resident recipient of the rent for which special arrangements need to be made. Obviously, enforcement of a withholding tax may be difficult, or even impossible, when the rental income is paid to the owner by a person who is not a resident of the country where the immovable property is located. However, once the existence of income from immovable property located in a country is known, that property may provide recourse to the tax administration to collect the taxes due if not duly paid.

As regards the reverse situation of residents deriving income from immovable property located in the other country, generally Article 23<sup>67</sup> of the applicable treaty includes the obligation for the country of residence to provide relief of double taxation on the relevant income.

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<sup>66</sup>In some cases, this is also combined with an option for the taxpayer to opt for taxation on a net income basis via assessment.

<sup>67</sup>See Article 23 of both the United Nations and OECD Model Conventions, which deals with methods for the elimination of double taxation. Double taxation relief may be given either by way of exemption of the income, or by way of credit of any foreign taxes levied in the other country on that income. On these aspects, see chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

In the case of taxation by assessment by the tax authorities, it seems useful to include a requirement that the taxpayer should explicitly mention in the tax return whether relief for double taxation is claimed. In the case of self-assessment, it would also be desirable to have such information available, as the tax authorities would then be aware that such relief has been claimed and, thus, may decide to check whether the taxpayer is indeed entitled to it or not.

If the income derived from the immovable property in the other country should have been reported but this was not done, it may be difficult for the authorities of the residence country to discover that. Besides limited options of fiscal intelligence (which may be successful, for instance, if the resident advertises that a house is for rent), automatic international exchange of information with respect to the possession of immovable property may provide a solution.

#### **4.4 Dividends, interest and royalties**

Aspects of tax treaty application regarding dividends, interest and royalties will be dealt with together, as most countries impose a withholding tax on the gross amount of these payments made to non-residents. The withholding agent is responsible for withholding the correct amount of tax. Such a system is, of course, attractive to the tax authorities from the perspective of both technical simplicity and effective enforcement.

Due to the allocation of taxing rights with respect to these types of income under tax treaties,<sup>68</sup> the country of source is usually only allowed to tax the income up to a certain percentage of its gross amount. If the domestic source tax exceeds the level of tax allowed under the treaty, arrangements need to be made to provide for any reduction or exemption of source country taxation, as may be required.

Although, as mentioned above, there are no generally accepted standard procedures for providing treaty benefits, in the case of cross-border payments of dividends, interest and royalties, source countries generally apply either a system of refund or a system of reduction of the withholding tax at source to grant the benefits to a resident of the other treaty country, who is the beneficial owner of the income.

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<sup>68</sup>See *supra* sections 3.3-3.5.

#### 4.4.1 Refund method

In the case of the refund method, tax is withheld according to the domestic law of the source country, and, subsequently, the non-resident beneficial owner can file a request for refund with the designated tax authorities<sup>69</sup> if the amount withheld exceeds the limit imposed by the tax treaty. For example, if 30 per cent withholding tax was levied on the gross amount of the payment of income under domestic law, and the tax treaty allocated only a right to levy 10 per cent tax on the gross amount of the payment, the refund would amount to 20 per cent. In the case of portfolio investments, like securities, such requests are often made on behalf of the taxpayer by financial intermediaries, like banks. Of course, such intermediaries must be able to show proof of authorization to act on behalf of the taxpayer, for instance by a statement signed by the taxpayer.

In countries where such requests are frequently made, the requests for refund are generally made via a form,<sup>70</sup> which is specifically designed for each category of income, and through which relevant information needs to be provided. The forms may be either in paper or electronic format.

Generally, the information to be provided includes at least the following elements:

- Name, address, tax identification number<sup>71</sup> and bank account of the recipient
- The amount of income and the date at which it was received, as well as proof of the amount of tax withheld
- If the tax treaty provisions distinguish among various types of dividends, interest and royalties to which different treaty rates

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<sup>69</sup>Often, this is the inspector who is competent for the withholding agent, or a special entity dealing with non-resident taxpayers.

<sup>70</sup>Generally, accompanying instructions to the form are provided, in which the statutory deadline for application can also be mentioned.

<sup>71</sup>It is also advisable to include the taxpayer's tax identification number in the country of residence as that may promote taxpayer compliance in the latter country and also enable a more efficient exchange of information between the tax authorities of the treaty countries.

apply, a statement indicating which category of income and which percentage of tax is considered applicable

- If it is relevant for the identification of the withholding tax rate applicable to dividends, information about the percentage of share capital held, and
- A statement by the tax authorities of the country of residence of the recipient confirming that the person is a resident of that country (referred to as certificate of residence<sup>72</sup>).

Furthermore, specific additional requirements may apply, like a statement by the recipient that he/she is the beneficial owner of the income,<sup>73</sup> or other requirements in the case of specific anti-avoidance provisions.<sup>74</sup>

Besides the certificate of residence, the taxpayer may also be required to acquire a statement by the tax authorities of the residence country as to whether certain other requirements have been met. However, as that puts an additional burden on these tax authorities, it is very important that such forms or procedures are agreed upon between the relevant competent authorities of the treaty countries. In order to avoid fraud with the use of such forms, it may be agreed between the treaty countries that the forms duly certified by the competent authorities of the country of residence of the recipient will be sent directly to the competent authorities of the source country.

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<sup>72</sup>It should be noted that issues have been raised about the value of such certificates. These relate, for instance, to the question of whether the tax authorities of the country of source should rely on such statements when deciding about granting treaty benefits, as well as to situations where an entity is considered as transparent in the residence country (and, thus, statements regarding the residence of the participants in such an entity may be provided), but as non-transparent in the source country (where the entity itself will not be considered as a resident liable to tax in the residence country). Such issues of treaty entitlement have been addressed in chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler.

<sup>73</sup>Such self-certification is for instance included in the forms developed in the context of the OECD Treaty Relief and Compliance Enhancement (TRACE)—Implementation Package, which is dealt with *infra* in section 4.4.3.

<sup>74</sup>See chapter II, Persons qualifying for treaty benefits, by Joanna Wheeler.

It is also advisable for the tax authorities of the source country to regulate this procedure and related forms via decree or other regulations, which may then be published, for instance, in the State bulletin of the country. Some countries agree in a mutual agreement with the competent authority of the other country to exchange (a summary of) such procedures, which can then also be published in the other country, for the benefit of its taxpayers.

The refund could be based on a formal decision entitling the taxpayer to file an appeal against it.

A refund procedure is attractive to the source country from a budgetary perspective, as the country keeps the tax withheld until the application has been received and verified and the refund has been made. However, it is not attractive to foreign investors, as initially they only receive the payments as reduced by the full withholding applicable under the domestic law of the source country. This is especially burdensome if the refund is not made within a reasonable time.

#### **4.4.2 Reduction at source method**

In order to improve the attractiveness of a country to foreign investment, the method of reduction of taxation at source is increasingly used, while the refund method is still available in case the formalities could not be finalized and communicated to the withholding agent before the time of the payment of the income.

Generally speaking, this method also works with paper or electronic application forms which have requirements similar to those mentioned above in the case of refund, including the certification of the residency of the recipient by the competent authorities of the country of residence. After filing the applications, and verification and approval by the designated tax authorities of the source country,<sup>75</sup> the (appealable) decision is sent by the tax authorities of this country to the taxpayer, or directly to the withholding agent, who is then allowed to immediately apply the limitation imposed by the treaty and to withhold the reduced amount of tax on the payments made. However, if the procedure is started at a late stage, or if the authorities involved cannot

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<sup>75</sup>In this case, probably the inspector who is competent for the activities of the withholding agent.

deal with the requests in a timely manner, the withholding agent may not be able to apply the reduction at the time of payment, and then the refund method needs to be applied.

Usually, a separate form needs to be filed for each payment; however, to be efficient, it is increasingly agreed between the competent tax authorities — especially in the case of regular payments, such as those on loans, licenses or shareholdings which last several years — that the certificate of residence and the approval are valid for a number of years. In such cases, however, the taxpayer must immediately give notice to the relevant tax authorities concerned if circumstances have changed.

In some countries, withholding agents can themselves decide to directly apply the reduced tax treaty rate if they consider that the taxpayer has sufficiently demonstrated that they are entitled to such benefits. Withholding agents may, however, be reluctant to do that, because if it happens that the non-resident taxpayer was not entitled to the treaty benefits, the withholding agent may be held liable to pay the additional tax due, as well as fines, to the tax authorities.

Finally, in cases where the source State is allocated a right to levy a tax on dividends, interest and royalties, the country of residence will have to provide relief for the avoidance of double taxation, in accordance with Article 23 of both the United Nations and OECD Model Conventions.<sup>76</sup> Generally, such relief will be requested by the taxpayers when filing their tax return or by self-assessment. If the income should have been reported and this was not done, such fraud could only be discovered by fiscal intelligence or through international exchange of information.

#### **4.4.3 Treaty Relief and Compliance Enhancement (TRACE)**

It should be clear from the methods described above that they may be quite burdensome to implement, both for taxpayers and tax authorities, and could create a serious obstacle for taxpayers to receive the treaty benefits.

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<sup>76</sup>Double taxation relief may be given either by way of the exemption method, or by way of the credit method. On these aspects, see chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

On 11 February 2013, the OECD published a “Treaty Relief and Compliance Enhancement (TRACE)—Implementation Package”,<sup>77</sup> which deals with the application of treaty benefits with respect to dividends and interests on securities held via financial intermediaries. Despite the fact that this system may be too expensive and too complicated for the purposes of many developing countries, it is interesting to mention some of its main features as it addresses several of the topics discussed above and contains some forms based on best practices, which—in an amended form—might still be useful to developing countries. The system is aimed at making the process of obtaining the treaty benefits of reduced withholding taxes on dividends and interest as efficient as possible, on the one hand, by minimizing administrative efforts and costs and, on the other hand, by enhancing countries abilities to ensure proper compliance with tax obligations.

Some of the main features of the system may be summarized as follows:

- Authorized intermediaries<sup>78</sup> would be allowed to claim exemptions or reduced rates of withholding tax on a annual “pooled basis” on behalf of their portfolio investors. (The TRACE—Implementation Package includes standard applications for granting that status and model contracts between such intermediaries and the source country, including agreed procedures and rules on the extent of the intermediaries liability for under-withholding, and it also provides for a review of the compliance of the intermediaries by independent reviewers).
- The claims will be supported by standardized investor self-declarations (in principle valid for five years) containing all relevant information, such as identification via name, address details and taxpayer identification numbers of the beneficial owner, and in the case of entities the type of entity, as well as statements of residence and beneficial ownership of the income, as well as specification of the types of income and exemptions or reduced rates claimed. Standard self-declaration

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<sup>77</sup>Available at <http://www.oecd.org/tax/exchange-of-tax-information/treatyreliefandcomplianceenhancementtrace.htm>

<sup>78</sup>Such as financial institutions, collective investment vehicles and custodians, as well as their approved affiliates.

forms for both individuals and entities are included in the TRACE — Implementation Package.<sup>79</sup>

- The source country will subsequently exchange the information on an automatic basis with the tax authorities of the country of residence of the investors, which will make the necessary verifications and inform the source country if certain taxpayers are not entitled to the treaty benefits.<sup>80</sup>

Generally, this procedure might not be available in the case of specific investor entities, such as partnerships, collective investment vehicles, etc., until their treatment<sup>81</sup> has been clarified by the tax authorities. Furthermore, it is recognized that specific domestic legislation may be needed to enable elements of the package to be implemented, or to clarify certain aspects thereof.

#### 4.5 Capital gains

As discussed above in sections 2.2 and 3.6, there are many differences in the taxation of capital gains in the various countries and, depending on the nature of the assets, different allocation rules in tax treaties.

In the case of Article 13 (1) and (2)<sup>82</sup> of both the United Nations and OECD Model Conventions, the source country has the full taxing right over the gains and, thus, there is no entitlement to reduction of the taxation in the source country on the basis of the tax treaty. Therefore, there is no need for specific administrative procedures for claiming treaty benefits.

In the case of Article 13 (3) of both the aforesaid Model Conventions, an exclusive taxing right over gains from the alienation of ships and aircraft operated in international traffic and boats engaged

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<sup>79</sup>To access these forms, see *supra* footnote 77.

<sup>80</sup>It is recommended that States agree on the timing and modalities via a specific memorandum of understanding (MOU).

<sup>81</sup>As to whether they can claim benefits themselves, or only the underlying participants in such entities can do so.

<sup>82</sup>These paragraphs deal with gains on immovable property located in the source country, and gains on the alienation of movable property of a permanent establishment situated in the source country, respectively.

in inland waterway transport is granted to the country in which the place of effective management of the enterprise is situated. Even if a source country could tax such gains under its domestic law, it should refrain from doing so if the place of effective management is in the other country. The tax on the profits of an enterprise is usually levied by assessment. In the case of self-assessment and assessment by the tax authorities, and assuming that there is no other taxable income in the source country, the taxpayer might not be required to file a nil assessment or a tax return, as no tax is due according to the tax treaty. If a non-resident tax liability exists under domestic law, the question will arise as whether the domestic law requires the non-resident to report the income and file a nil assessment or a tax return to claim the treaty benefit. This will depend on the relevant provisions in the domestic law of the country.<sup>83</sup>

As regards Article 13 (4) of both the United Nations and OECD Model Conventions, the situation is similar to the one dealt with under paragraphs 1 and 2 of this Article, because the source country, under the treaty, is also allowed to fully tax the gains on the alienation of shares if all the conditions provided under the treaty provisions are met. In such a case, the taxpayer will have to file a self-assessment or a tax return, provided that the gains are also taxable under domestic tax law. Thus, as there are no treaty benefits to be claimed, it is not necessary to introduce any further administrative arrangements for claiming these benefits.

The real challenge for tax administrations of the source country is to discover the taxable gain if the non-resident seller has not reported the income. This would be a matter of fiscal intelligence. In the case of a register in which information concerning the ownership of shares must be entered, or in case of a domestic resident buyer, the change of ownership in the register or the bookkeeping of the buyer, respectively, may point the tax administration to the non-resident's tax liability. If, however, the shares in the company or entity holding the immovable property have not been alienated, but rather are the shares in a company which, in turn, owns directly or indirectly the

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<sup>83</sup>The advantage of having such an obligation is that the tax authorities can check whether the treaty benefit was justified. On the other hand, it would impose administrative obligations in cases where no tax may be due.

company owning the immovable property, it may become very difficult to enforce a domestic tax liability.<sup>84</sup>

In the case of Article 13 (5) of the United Nations Model Convention,<sup>85</sup> the situation is similar for the source country to that under Article 13 (4) of both the United Nations and OECD Model Conventions. In this case, a taxing right is allocated by the treaty to the source country and, thus, there is no need to make arrangements for treaty benefits to be granted in the source country. If, under the domestic law, the non-resident seller is liable to tax, the problem will again be how to enforce such taxation if the gain is not reported by the taxpayer.

If the source country imposes a tax liability on the sale of shares by a resident of the other treaty country, which is not covered under Article 13 (2) or (4) of both the aforesaid Model Conventions (and neither by Article 13 (5) in the case of a treaty following the United Nations Model Convention), and the treaty allocates the exclusive taxing right on such gain to the country of residence,<sup>86</sup> then a treaty benefit needs to be granted by the source country. As taxes on such gains are usually levied by assessment, the claim for such exemption from tax in the source country could be made either when filing a tax return under a self-assessment system or when information is provided to the tax authorities under a system of assessment by the tax authorities. Also in this case, it is a matter of domestic law whether or not such filing needs to take place and whether such gains must be reported and an exemption claimed on the basis of the tax treaty, or only the taxable income must be reported after applying the treaty benefit.<sup>87</sup>

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<sup>84</sup>If existing at all for cases of indirect sale of shares or participations in other entities.

<sup>85</sup>This provision deals with the sale of shares in a company that is resident in the source country by a seller who is a resident of the other treaty country, and who owned a substantial participation in that company during a certain period of time.

<sup>86</sup>Article 13 (5) of the OECD Model Convention and Article 13 (6) of the United Nations Model Convention.

<sup>87</sup>In the latter case, the tax administration would have no indication that the treaty entitlement may need to be checked. On the other hand, administrative burdens would be avoided in cases where, generally, no tax is due.

In view of the problems of enforcing taxation on capital gains on the sale of shares, and especially in the case of indirect sales of shares when the domestic law and the treaty allow for that, some countries have introduced reporting requirements, or even an obligation on the buyer to withhold tax on the gross amount of the purchase price, in their domestic law.

If domestic tax liability on the sale of shares goes beyond what is allowed under an applicable tax treaty, arrangements will need to be made for the non-resident seller to enjoy treaty benefits. For instance, in the case of the above-mentioned withholding obligation on the buyer, this could be done by a provision in the law of the source country, which allows the buyer to refrain from withholding the tax subject to consent by the competent tax authority. Depending on the organization of the tax administration, that competent tax authority may be the tax inspector responsible for the area where the buyer resides or, in the special case of a non-resident buyer, a special entity of the tax administration which is responsible for the taxation of non-residents.

Finally, if the source country is allocated a right to levy a tax under Article 13 of both the United Nations and OECD Model Conventions, the country of residence, in accordance with Article 23 of both these Model Conventions, will have to provide relief of double taxation.<sup>88</sup> As discussed in the previous sections, if such gains need to be reported in the residence country and that has not been done, fiscal intelligence or international exchange of information may contribute to successfully combating such tax fraud.

## **5. Enforcement**

### **5.1 General aspects**

In this section, the following aspects regarding enforcement will be discussed:

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<sup>88</sup>This can be done by either the exemption method, or the credit method. On these aspects, see chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

- Legislative aspects
- Availability of information
- Organization of the tax administration applying the domestic law and tax treaties, and
- Collection of the taxes.

Only a selected number of these aspects will be analyzed, with specific respect to the types of income and gains covered in this chapter. Aspects regarding domestic law and international law will be dealt with separately. In the context of the latter, some attention will also be paid to the Foreign Account Tax Compliance Act (FATCA), which was enacted in the United States of America in 2010,<sup>89</sup> as it may have an impact on financial institutions and tax authorities in developing countries.

## 5.2 Aspects of domestic law

With respect to the domestic legal framework, several aspects may be important for the enforcement of taxation of the different types of income and gains dealt with in this chapter.

The following aspects regarding legislative issues can be considered:

- Is the legal basis for applying tax treaties sufficient (including both the application of substantive tax provisions and of formal provisions, such as, for instance, in the case of international exchange of information and assistance in the collection of taxes)?
- Have implementing decrees, regulations or forms (with accompanying instructions, including, for instance, information about statutory deadlines) been issued to clarify the procedures to apply for claiming treaty benefits?
- Is the notion of immovable property properly defined in domestic law and is there clarity regarding immovable rights?

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<sup>89</sup>FATCA is aimed at enforcing United States tax liability on United States taxpayers who hold unreported accounts via foreign financial institutions.

- Can indirect sales of immovable property, as dealt with under Article 13 (4) of both the United Nations and OECD Model Conventions, be taxed under domestic law?
- Is there a legal obligation to register ownership of immovable property in public registers?
- Is there an adequate definition of dividends, also taking into account hybrid financing and excessive payments of interest and of royalties in related party situations?
- Is there an adequate transfer pricing legislation in place to determine what constitutes excessive payments between related parties?
- Is the notion of interest properly defined and are there anti-abuse rules in the area of thin capitalization and is re-qualification of interest possible under these rules?
- Is there a clear notion of royalties, clarifying the differences between rights to use and (partial) alienation? Is the situation regarding payments for software clear? Is there a clear distinction between royalties and technical services?
- Is there an obligation to register the ownership of shares in companies?
- In the case of sale of shares in resident companies, is there a source rule/tax liability in the domestic law as provided under Article 13 (5) of the United Nations Model Convention?
- Is there general anti-abuse legislation or an anti-abuse doctrine developed in case law?
- Are there sufficient powers for the tax administration to do audits and acquire information, including from banks?
- Is the statute of limitations adequate in international situations, where it may take more time before information becomes available?
- Can decisions be appealed by taxpayers to independent tax courts to secure proper enforcement?
- Should certain taxes be imposed via (self-) assessment or via a withholding tax system?
- Should certain reporting requirements be introduced to discover taxable events or to be able to judge whether treaty application by the taxpayer was correct?

As regards information, the following points may deserve attention (besides the points regarding information already listed above):

- Is information regarding ownership of immovable property situated in the country available and used?
- Is information regarding payments of dividends, interest and royalties available and used?
- Is tax technical information on international tax issues (including texts of tax treaties concluded, case law, literature, etc.) available within the tax administration for persons involved in these matters?
- Can international assistance regarding information be effectively used?
- Is there sufficient fiscal intelligence to gather relevant information regarding the various types of income (for instance, to find out whether shares have been alienated by non-resident owners)?

With respect to the organization of the tax administration, the following points may be relevant in this context:

- Is there enough international tax expertise in the units dealing with international tax matters?
- Are there enough resources available to apply tax treaties?
- Should certain international tax matters be dealt with by local units or by specialized units (such as, for instance, taxation of non-residents by assessment and decisions to allow withholding agents to provide tax treaty benefits at source)?
- Are there sufficient language skills in the units dealing with international tax matters?
- Is there a separate fiscal intelligence unit for gathering and distributing relevant tax information on international tax matters?

As regards the collection of taxes, the following points may deserve attention:

- Are withholding tax systems adequately applied?
- Can international situations be properly handled?
- Can international assistance in collection be provided or requested?

- Can refunds be managed properly and are there incentives to grant them within acceptable time limits?

### **5.3 Aspects of international law**

With respect to the international legal framework, the following aspects may be important for the enforcement of taxation of the different types of income and gains dealt with in this chapter:

- Do tax treaties allocate taxing rights to a country which cannot be enforced by that country?
- Do the tax treaties or administrative cooperation treaties contain adequate provisions on the exchange of information?
- Do tax treaties or administrative co-operation agreements contain adequate provisions regarding assistance in the collection of taxes?
- Do tax treaties contain adequate anti-abuse provisions to secure their proper application and enforcement of the relevant taxes?

### **5.4 Foreign Account Tax Compliance Act**

Although primarily focused on combating tax evasion by United States taxpayers, it is useful to briefly discuss the Foreign Account Tax Compliance Act (FATCA), which was enacted in the United States in 2010, as it can be applicable in relation to financial institutions in developing countries with United States account holders.

This legislation is aimed at combating tax evasion by United States taxpayers via the use of accounts (depository or custodian accounts) kept at foreign financial institutions (FFIs), or any equity or debt in such financial institution, or via certain non-financial foreign entities (NFFEs). This legislation imposes, amongst other things, reporting requirements on FFIs and NFFEs. For instance, FFIs should report to the United States Internal Revenue Service (IRS) any United States and foreign source income of United States taxpayers enjoyed directly by them via the FFI or via United States owned foreign entities, and in that context review all accounts maintained by the FFI and its affiliated group, as well as look through foreign shell companies and

determine whether United States taxpayers are the beneficial owners of the income. They should also withhold and pay over to the IRS 30 per cent of any pass-through payment by the FFI to non-participating FFIs or to recalcitrant account holders. Non-compliant or non-participating FFIs will face a 30 per cent withholding tax on any payments to them of dividends, interest and royalties and other periodic payments from United States sources, and of gross proceeds from the sale or disposition of property that can produce United States source interest or dividends. To address foreign local law impediments to comply with FATCA, simplify practical implementation and reduce costs for foreign FFIs, intergovernmental agreements have been concluded, or are being concluded, by the United States with 50 jurisdictions, based on model Inter-Governmental Agreements (IGAs), under which the FFI's provide certain agreed information to the tax authorities in their own country, which these authorities would then pass on to the IRS via exchange of information.

One of the two model IGAs provides for reciprocity of obligations, thus obliging the United States to provide such information to residents of the other country.

Although the focus of FATCA is different from the aim of tax treaties, which is to provide treaty benefits to own residents (that is to say, relief from double taxation) or to residents of another country (that is to say, reduction of source taxation) entitled to such benefits, there might be certain points of contact with tax treaty application, for instance, in the area of documentation requirements, forms etc. The TRACE Group, which developed the TRACE system discussed in section 4.4.3, will also be working on ensuring that the reporting requirements under TRACE are aligned with those of other reporting regimes, such as FATCA, in order to reduce implementation costs for all stakeholders involved.



## Chapter VIII

### Dispute resolution: the Mutual Agreement Procedure

HUGH J. AULT\*

#### 1. Introduction

##### 1.1 Function of the Mutual Agreement Procedure

Article 25 of the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>1</sup> (United Nations Model Convention) is a very important procedural provision for the application and implementation of the bilateral treaties based on the Model Convention. It provides for the establishment of a “mutual agreement procedure” (MAP) which enables the parties to the treaty to better carry out the substantive provisions contained therein, which allocate taxing rights. The MAP is administered by the “competent authorities”, who are generally named in Article 3 (e) of the treaties based on the United Nations Model Convention. It is very important to make clear the persons who will be designated as competent authorities. Typically, they come from the ministry or tax authority (that is to say, the responsible branch of the governments of the contracting States). They are the persons who are normally responsible for administering the treaty and the mutual agreement procedure in Article 25 sets forth the agreed rules and principles for ensuring that the functions of the treaty are properly adhered to. The role of the competent authorities in Article 25 is to “endeavour to resolve” by mutual agreement any difficulties or doubts arising as to the application of the treaty. It applies in connection with all articles of the convention.

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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

In order to ensure the proper functioning of the treaty, Article 25 gives rights to taxpayers who believe that they are not being taxed in accordance with its substantive rules to request that the competent authorities bring their taxation into accordance with those rules, either unilaterally or in consultation with their treaty partner. Taxpayer-initiated cases represent the bulk of cases under Article 25. Cases would typically involve transfer pricing disputes, allocation of profits to a permanent establishment under Article 7, the question of the existence of a permanent establishment or the appropriate residence of a person or company. Access to the MAP procedure should be broadly interpreted as it is essential to the proper functioning of the treaty.

Beyond taxpayer-initiated cases, the competent authorities may undertake themselves to resolve any “doubts and uncertainties” concerning the application of the treaty, for example, by establishing an agreed meaning to an undefined term in it, thus ensuring its uniform application. Finally, there is a broad provision which allows the competent authorities to consult together for the elimination of double taxation in cases not otherwise provided for in the treaty.

The remainder of this chapter will describe in some detail the various situations in which the MAP can be used to ensure the proper functioning of the treaty. Two important sources of additional material on the MAP are the United Nations Guide to the Mutual Agreement Procedure under Tax Treaties<sup>2</sup> (United Nations Guide to the MAP) and the Organisation for Economic Co-operation and Development (OECD) Manual on Effective Mutual Agreement Procedures<sup>3</sup> (MEMAP) and reference will be made to these materials in the descriptions below.

## **1.2 How the MAP operates**

Article 25 (4) of the United Nations Model Convention authorizes the competent authorities to deal with each other directly, either in writing or orally. This avoids the cumbersome formal rules which usually

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<sup>2</sup>The latest draft is available at [http://www.un.org/esa/ffd/tax/seventhsession/CRP\\_4\\_clean.pdf](http://www.un.org/esa/ffd/tax/seventhsession/CRP_4_clean.pdf).

<sup>3</sup>Available at <http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementprocedures-index.htm>.

govern intergovernmental communications and allows efficient communication between the two tax authorities. Communications can take various forms, including face-to-face meetings, exchanges of documents or positions papers and other forms of informal contacts. Article 25 (4) foresees that the two competent authorities may develop bilateral procedures to deal with the various detailed questions which are necessary to implement the MAP. All information exchanged under the MAP procedures is subject to the confidentiality requirement of Article 26.

### **1.3 Outcomes of the MAP**

In the case of a taxpayer-initiated MAP, the normal result is an agreement between the competent authorities as to how the treaty should be applied in the taxpayer's case with both of them thus applying the same interpretation of the treaty. The taxpayer typically has the right to accept the results of the MAP and give up his domestic remedies in the two jurisdictions or to reject the MAP and seek judicial relief under the domestic legal systems. As discussed below in section 4, if the treaty provides for arbitration, the resulting MAP may have involved a supplementary arbitration process.

In the case of a competent authority-initiated procedure, the result will typically be the publication of some other sort of advice indicating how the two States will apply the treaty. Cases involving the relief of double taxation not otherwise provided for in the treaty, which are rare, can either be taxpayer specific or result in some form of general guidance. An example would be the treatment of a third country resident who had a permanent establishment in both States but, lacking a residence connection, had no right to claim relief from double taxation in either State.

### **1.4 Relation between the MAP and domestic legal remedies**

As specifically provided in Article 25 (1) of both the United Nations Model Convention and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>4</sup>

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<sup>4</sup>Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (loose-leaf).

(OECD Model Convention),<sup>5</sup> the MAP is in principle available to the taxpayer in addition to his normal legal remedies under domestic law. Thus, it is important to clarify clearly the exact relation between the two systems of relief which is a matter of domestic law. If a domestic court has already reached a decision in the case at issue, the competent authority may be bound by the decision of the domestic court and may not be in a position to provide any unilateral relief. In addition, its ability to deal with the other State in the MAP may be limited to seeking to obtain double tax relief from the other State. Where the application of domestic relief and the MAP are both open to the taxpayer, there should be some rules establishing the relation between the two systems. Some States require the taxpayer to waive all of his rights under domestic law before the competent authorities will accept a case for the MAP, but this practice is not usual. States taking this position are concerned about devoting the resources and efforts to find a MAP solution which the taxpayer may ultimately reject. More commonly, however, the taxpayer will only be required to suspend the active pursuit of his domestic law remedies while the MAP case is being implemented. In such cases, it is important that the taxpayer take the necessary steps as required under domestic law (obtaining a waiver of time limits, submitting a protective claim, etc.) to keep his domestic law remedies available should, in the end, the MAP not produce a satisfactory result. Alternatively, it is possible for the period in which the MAP claim is timely (see section 2.2.3) to be either suspended or extended while the domestic legal proceeding is going on. Whichever approach is taken, it is important to have clear rules for both the taxpayer and the tax administration as to the relation between the two procedures.<sup>6</sup>

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<sup>5</sup>Any references to the United Nations Model Convention and Commentary are to the 2011 version unless otherwise noted. Similarly, any references to the OECD Model Convention and Commentary are to the 2010 version unless otherwise noted.

<sup>6</sup>United Nations Guide to the MAP, paragraphs 72-77.

## **2. Taxpayer-initiated MAP**

### **2.1 General**

By far, most MAP cases involve a complaint by the taxpayer that it is not being taxed in accordance with the substantive rules in the treaty allocating taxing jurisdiction between the two contracting States, thus resulting in unrelieved double taxation which defeats the purpose of the treaty. This can involve a dispute with either the source country as to whether that country has the right to tax under the treaty or with the residence State as to when it is required to give double tax relief.

### **2.2 Basic requirements for a taxpayer-initiated MAP**

To make a request for a MAP, Article 25 of both the United Nations and OECD Model Conventions requires that the taxpayer be a resident of one of the contracting States and establish that an action by one or both of the States results or “will result” in taxation not in accordance with the treaty. The request is made to the State of which the taxpayer is a resident, even if the claim relates to taxation imposed by the other State. It should be noted that the taxpayer has the right to make a MAP request if the actions “will result” in its being inappropriately taxed. It is not necessary that the taxpayer has in fact already been charged to tax. Thus, for example, if a law has been enacted that, when applied to the taxpayer would, in its view, result in inappropriate taxation, the taxpayer would be able to request a MAP provided it had or expected to have income of the type covered by the newly enacted law.

#### **2.2.1 Information requirements**

For the MAP to be successful, the taxpayer requesting it must provide the necessary information for the competent authorities to assess the case. Some countries have developed a formal procedure which must be followed by the taxpayer in its MAP requests. While the requirements vary somewhat, the following basic information should be required in order for the MAP request to be processed.<sup>7</sup>

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<sup>7</sup>United Nations Guide to the MAP, paragraph 94.

- (a) The name, address and any taxpayer identification number of the taxpayer;
- (b) The name, address and any taxpayer identification number of the related foreign taxpayer(s) involved (for transfer pricing cases);
- (c) The foreign tax administration involved and, if relevant, the regional or local tax administration office that has made, or is proposing to make, the adjustment(s);
- (d) The tax treaty article that the taxpayer asserts is not being correctly applied, and the taxpayer's explanation of how it believes the article should be interpreted and/or applied;
- (e) The taxation years or periods involved;
- (f) A summary of the facts, including the structure, terms and timing of all relevant transactions and the relationships between related parties (the taxpayer should advise the competent authority of how the facts may have changed during or after the relevant taxable period, and of any additional facts that come to light after the submission of the MAP request);
- (g) An analysis of the issues for which competent authority assistance is requested and the relevant legal rules, guidelines or other authorities (including any authorities that may be contrary to the conclusions of the taxpayer's analysis). The analysis should address all specific issues raised by either tax administration as well as the amounts related to the adjustment(s) (in both currencies and supported by calculations, if applicable);
- (h) For transfer pricing cases, any documentation required to be prepared under the domestic legislation of the taxpayer's State of residence (where the volume of a taxpayer's transfer pricing documentation is large, a competent authority may determine that a description or summary of the relevant documentation is acceptable);
- (i) A copy of any other relevant MAP request and the associated documents filed, or to be filed, with the competent authority of the other contracting State, including copies of correspondence from the other tax administration, copies

of briefs, objections, etc., submitted in response to the action or proposed action of the tax administration of the other contracting State (translations of relevant documents may be helpful, and, where documentation is voluminous, a competent authority may determine that a description or summary of such documentation may be acceptable);

- (j) A statement indicating whether the taxpayer or a predecessor has made a prior request to the competent authority of either contracting State with respect to the same or a related issue or issues;
- (k) A schedule of the relevant time limits and statutes of limitation in each jurisdiction (whether imposed by domestic law or the tax treaty) with respect to the taxable periods for which MAP relief is sought (in cases of multiple taxpayers, a schedule for each taxpayer);
- (l) A statement indicating whether the taxpayer has filed a notice of objection, notice of appeal, refund claim, or any other comparable document in either of the relevant jurisdictions;
- (m) A statement indicating whether the taxpayer's request for MAP assistance involves issues that are currently or were previously considered by the tax authorities of either contracting State as part of an advance pricing arrangement, ruling, or similar proceedings.

Where the taxpayer does not supply sufficient evidence or does not cooperate in the production of the necessary information, the competent authority is justified in suspending consideration of the request, or, if necessary, not accepting the case.

### **2.2.2 Requirement of Payment**

Article 25 of both the United Nations and OECD Model Conventions does not by its terms require the taxpayer to have paid the tax before making the MAP request. Indeed, in some cases, the request may be timely even before the tax has been charged. While some States have required that the tax be collected prior to the beginning of the MAP, the better practice is to suspend or defer the obligation to pay the tax

during the period of the MAP.<sup>8</sup> Where the competent authority has found the taxpayer's MAP request to be justified, it would not be consistent with the basic purposes of a MAP resolution to further require the advance payment of the tax obligation in dispute. If the taxpayer ultimately prevails in its claim and the tax paid in advance is refunded, the taxpayer will have suffered the loss of the time value of money loss in connection with the payment. While these issues can in some cases be resolved by the application of interest payments and charges, it is simpler and more consistent with the underlying goals of the MAP not to require payment. This may in some cases require changes in the country's domestic law to ensure that collection during the MAP can be suspended.

### **2.2.3 Time limits for taxpayer-initiated MAP**

Article 25 (1) of both the United Nations and the OECD Model Conventions provides that the taxpayer must present the case for MAP relief within three years of the first "notification" of the action taken by one of the States which will result in taxation not in accordance with the treaty. This requirement is to protect tax administrations from late-filed objections to the application of the treaty rules. The three-year period is only recommended and States are of course free in their bilateral negotiations to agree on a different period. The period may also be related to the domestic rules regarding statute of limitations and timeliness of claims. In this connection, it should be noted that the taxpayer may be able to bring a MAP request as soon as it becomes clear that inappropriate taxation may result (see section 2.2 above). This may occur substantially before the actual notification of the action which triggers the three-year period.

The determination of exactly what constitutes "notification" for purposes of establishing the period in which a taxpayer can present a claim is very important and is clarified in the Commentaries to the Model Conventions.<sup>9</sup> The notification will generally be the act of

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<sup>8</sup>MEMAP Best Practice No. 21.

<sup>9</sup>Paragraph 21 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 21 of the Commentary on Article 25 of the OECD Model Convention.

taxation itself, for example, the payment of an amount which is subject to a withholding tax or the actual issuance of a notice of assessment or official demand for collection. In cases of self-assessment, in general, the taxpayer's filing of a tax return does not in itself constitute a notification. There must be some action on the part of the tax authorities, such as the denial of a claim for refund or the issuance of a notice of liability which makes the taxpayer aware that taxation not in accordance with the treaty is going to be imposed.

### **2.3 Evaluation by the competent authority of the MAP request**

When a MAP request fulfilling the above requirements has been submitted to the competent authority of the residence country, it must determine "if the objection appears to be justified".<sup>10</sup> While this language seems to give wide discretion to the competent authority of the residence country, the grounds on which such a request in practice has been denied are quite limited and the best practice is to be liberal in granting MAP requests.<sup>11</sup> In some cases, there may be a domestic law impediment to accepting the case, but this should be a most unusual situation.<sup>12</sup> Some States deny access to the MAP where the transaction in question has been found to be "abusive", for example, covered by a domestic anti-avoidance provision. However, the Commentaries to the Model Conventions<sup>13</sup> indicate that this generally should not be a basis to deny access. On the other hand, where there are violations of domestic law which involve significant penalties, some States may wish to deny access to a MAP. If this is the case, it should be clearly indicated in the treaty. If granting taxpayer relief would be contrary

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<sup>10</sup>Article 25 (2) of both the United Nations and OECD Model Conventions.

<sup>11</sup>MEMAP Best Practice No. 9.

<sup>12</sup>Paragraph 27 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 27 of the Commentary on Article 25 of the OECD Model Convention.

<sup>13</sup>Paragraph 26 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 26 of the Commentary on Article 25 of the OECD Model Convention.

to a final court decision that the tax authority is required to follow, a MAP request might be rejected (see section 1.4).

## **2.4 Unilateral resolution**

When a request for a MAP has been accepted, Article 25 of both the United Nations and OECD Model Conventions provides that in the first instance, the residence country should attempt to resolve the case unilaterally, for example, by granting a tax credit or giving an exemption which would be justified in the particular circumstances of the case. If unilateral resolution is not successful, the competent authority of the residence State then contacts the competent authority of the partner State to begin bilateral discussions.

## **2.5 Structure of bilateral MAP negotiations**

If the requested residence State cannot solve the inappropriate taxation unilaterally, it then typically opens discussion with the other State regarding a solution to the inappropriate taxation asserted by the taxpayer in its request. While these steps can vary and may be established under the procedures foreseen in Article 25 (4) of the United Nations Model Convention, the first step in this process is usually for the residence State to develop a position paper setting forth its views of the case. The initial position paper would typically cover the following points:<sup>14</sup>

- (a) The name, address and taxpayer identification number (if any) of the taxpayer making the MAP request and of related persons in the other contracting State (if relevant), and the basis for determining the association;
- (b) Contact information for the competent authority official in charge of the MAP case;
- (c) A summary of the issue(s) presented, the relevant facts and the basis for the tax administration action that is the subject of the MAP request;
- (d) The taxation years or periods involved;
- (e) The amount of income and the relevant tax for each taxable year, if applicable;

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<sup>14</sup>United Nations Guide to the MAP, paragraph 170.

- (f) A complete description of the issue(s) presented, the relevant tax administration actions and adjustments, and the relevant domestic laws and treaty articles;
- (g) To the extent relevant and appropriate, calculations and supporting data (which may include financial and economic data and reports relied upon by the tax administration, as well as relevant taxpayer documents and records).

After the receipt of the initial position paper from the competent authority of the residence State, the other State may find it useful to provide a rebuttal or response statement. This paper would be focused on responding to the points raised in the initial position paper and would typically contain:<sup>15</sup>

- (a) An indication whether a view, resolution or proposed relief presented in the initial position paper can be accepted;
- (b) An indication of the areas or issues where the competent authorities are in agreement or disagreement;
- (c) Requests for any required additional information or clarification;
- (d) Other or additional information considered relevant to the case but not presented in the initial position paper; and
- (e) Alternative reasoned proposals for resolution.

After this initial exchange of views, the competent authorities will continue their discussions, which will typically end in a face-to-face meeting in which a final resolution of the case may be achieved. If no successful agreement is reached, the issues preventing the resolution of the case may be submitted to arbitration, as discussed in section 4.2 below, if alternative B of Article 25 of the United Nations Model Convention is followed.

### **2.5.1 Participation of the taxpayer in the MAP process**

While the taxpayer has a right under Article 25 of both the United Nations and OECD Model Conventions to submit a request for a MAP, the process, once undertaken, is a government-to-government relationship. Nonetheless, successful MAP requires close cooperation

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<sup>15</sup>United Nations Guide to the MAP, paragraph 173.

between the taxpayer and the competent authorities. The taxpayer provides the necessary information to the competent authority in its State of residence which, in turn, communicates that information to the other State. It may be necessary to request further information or clarifications from the taxpayer. Depending on the situation, the competent authorities may permit the taxpayer to submit briefs or make presentations to either one or both of them. These presentations may also contain taxpayer proposals for the resolution of the case. However, direct taxpayer's participation in the competent authority negotiations would not be appropriate, given the differing interests of the parties, though timely indications to the taxpayer of the status of the negotiations would be useful in moving the case forward.<sup>16</sup>

## **2.6 Implementation of the MAP result**

### **2.6.1 General**

Assuming that the MAP negotiations have successfully reached an agreement as to the appropriate interpretation and application of the treaty in the case, several steps are still required before the MAP can be implemented. In the first place, the agreement must be accepted by the taxpayer. The taxpayer is not bound by the agreement reached by the competent authorities, but must accept it before it can be implemented. In addition, if the taxpayer had initiated or still has the right to initiate domestic judicial procedures, it is appropriate at this time for the taxpayer to waive any rights to further judicial proceedings in order to take advantage of a solution which involves a uniform interpretation and application of the treaty.<sup>17</sup> However, if the taxpayer chooses to wait until the conclusion of the judicial procedures before accepting the agreement, the taxpayer cannot be assured that the proposed agreement will still be available.<sup>18</sup> In addition, it might be possible to

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<sup>16</sup>United Nations Guide to the MAP, paragraphs 149-54.

<sup>17</sup>Paragraph 45 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 45 of the Commentary on Article 25 of the OECD Model Convention.

<sup>18</sup>Footnote 49 in the Commentary on Article 25 of the United Nations Model Convention.

condition the agreement on its acceptance by the taxpayer within a certain time period.

The legal status of the agreement and the actual steps necessary for its implementation will depend on the normally applicable procedural rules in the two States. However, Article 25 (2) of both the United Nations and OECD Model Conventions specifically indicates that an agreement shall be implemented notwithstanding any time limits of domestic law. This obligation may require changes in the domestic limitation rules to provide a specific exception for adjustments arising under an agreement.

### **2.6.2 Interest**

In many cases, the agreement which has been reached in the MAP will involve possible interest charges on tax deficiencies and interest payments on tax refunds. States differ over how interest charges and refunds should be treated under Article 25.<sup>19</sup> The treatment of interest may differ in the domestic systems of the two countries. Despite these difficulties, it would be desirable from the point of view of the effective functioning of the MAP that a symmetrical treatment of interest charges and expense could be established in the implementation of the agreement.

## **2.7 Application of the MAP to cases arising under Article 9 dealing with transfer pricing**

The bulk of cases involving MAP arise in the context of Article 9 and transfer pricing. In these cases, there are some special considerations which must be taken into account. MAP cases dealing with, for example, the existence of a permanent establishment or the allocation of profits between a permanent establishment and the head office, typically involve so-called “juridical” double taxation; the same income is being taxed by both States to the same taxpayer. In the case of Article 9, however, where there is a disagreement as to the transfer price between

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<sup>19</sup>Paragraph 49 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 49 of the Commentary on Article 25 of the OECD Model Convention.

related entities, the resulting double taxation is “economic”, that is to say, the same item of economic income is being taxed to two different taxpayers. Thus, when a transfer pricing adjustment is made to increase the income of one of the related parties, that same economic income will have also been taxed by the other State in the hands of its resident taxpayer. The application of Article 25 to this situation involves some special considerations.

### **2.7.1 “Corresponding” or “correlative” adjustments**

The United Nations Model Convention and many existing treaties contain a special provision in Article 9 (2) which deals with the situation of potential economic double taxation. That paragraph provides that where one State makes an adjustment of the profits of its taxpayer (the “primary” adjustment) to reflect what in its judgment the appropriate transfer price should be, the other State “shall” make an appropriate adjustment (the “corresponding” or “correlative” adjustment) to its taxation of the related party in its jurisdiction. Thus, potential double taxation of the same economic income will be eliminated.

On its face, the primary adjustment by the first moving State would seem to require the other State to follow the determination of that State in establishing the appropriate transfer price. However, paragraph 6 of the Commentary on Article 9 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 9 of the OECD Model Convention, indicates that the second State is only required to agree to the adjustment if it considers the adjustment justified “both in principle and as regards the amount”. If this is not the case, that is to say, if the second State does not agree with the primary adjustment made by the first State, then paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 10 of the Commentary on Article 25 of the OECD Model Convention, makes clear that in such a case the MAP can be used to determine if the adjustment is “well founded” and appropriate in amount. In this way, a MAP will be available to relieve economic double taxation. However, even when, in general, a State is willing to agree to a corresponding adjustment, Article 9 (3) of the United Nations Model Convention provides that no such adjustment is required if one of the parties involved in the primary adjustment is liable for a penalty based on fraud, gross negligence or wilful default.

Some treaties, especially those signed before 1977, do not contain Article 9 (2). Nonetheless, paragraph 9 of the Commentary to Article 25 of the United Nations Model Convention, quoting paragraph 11 of the Commentary on Article 25 of the OECD Model Convention, takes the position that economic double taxation resulting from transfer pricing adjustments is not within the “spirit” of the treaty and thus should fall within the scope of MAP even in the absence of Article 9 (2) in the treaty. Not all States share this view and this is a point which is important to clarify in treaty practice.

### **2.7.2 “Secondary” adjustments**

Once an adjustment to the income of the two parties has been agreed in the MAP, there remains the question of how to implement it. In effect, on the basis of the adjustment, the actual cash or assets of the taxpayer which are shown on the taxpayers’ books do not correspond to the adjustment amount of the income. Paragraph 44 of the Commentary on Article 25 of the United Nations Model Convention deals with some of these situations. Thus, for example, if income is allocated to a parent company for the payment of services provided to a related subsidiary and taxed to the parent company, it would be possible for the subsidiary company to make a repayment to the parent company of the “excess” cash it had as a result of the adjustment. This could be provided for by allowing the parent company to establish a receivable for the amount of the excess which the subsidiary could pay to the parent company on a tax neutral basis in both the source and resident states. Other techniques are available to work out these adjustments.

### **2.7.3 Other procedural issues in Article 9 cases**

Since a transfer pricing adjustment can be proposed by either State, and as Article 25 recognizes that economic double taxation should be covered by a MAP, the taxpayer in either State could be the one to request mutual procedural relief from its State of residence. For example, suppose that State S proposes to increase the profits of S Co., a company resident in State S, because of a transfer pricing adjustment. Suppose also that those profits have already been taxed by State P in the hands of P Co., an associated company resident in State P, on the basis of the originally determined transfer price. Thus, P Co. could

request a MAP from its State of residence. If State P, in fact, agreed with the primary adjustment proposed by State S, it could deal with the resulting economic double taxation by making a corresponding adjustment unilaterally, as is provided for in Article 25. If, as is more likely, it does not agree with the adjustment, State P would then be obligated to contact State S to begin bilateral consultations. Similarly, S Co., the taxpayer to whom the primary adjustment has been made, could also make a request for a MAP to State S, again on the basis of the economic double taxation arising from the adjustment. In transfer pricing cases, therefore, the administrative procedures must be adapted to the situations in which both taxpayers have the right to request a MAP.

### **3. General “best practices” in structuring a MAP**

Both the United Nations Guide to the Mutual Agreement Procedure under Tax Treaties (United Nations Guide to the MAP) and the OECD Manual on Effective Mutual Agreement Procedures (MEMAP) provide very useful guidance in structuring and implementing MAP. This guidance is framed in terms of best practices and is distilled from the experience with MAP of both developed and developing countries. The recommendations, of course, must be evaluated in the light of each country’s background and context, but they provide valuable insights into how to make the MAP work most effectively.

#### **3.1 Developing guidelines and procedures for taxpayer’s access to a MAP (United Nations Guide to the MAP, paragraph 92)**

For the MAP to function most effectively, it should be as transparent and accessible to the taxpayer as possible. Article 25 itself does not set forth rules or other guidelines for the taxpayer who wishes to use MAP. However, countries have found that the MAP can be encouraged by having a process that is as transparent and free from formalities as possible. Ideally, a country should develop and publicize appropriate forms, format and instructions as to how to begin the MAP request, the time deadlines which must be met and guidance as to the other formal requirements.

### **3.2 Competent authorities should make every effort to resolve cases on a principled and fair basis (United Nations Guide to the MAP, paragraph 49)**

It is important that the competent authorities approach each case on the basis of a principled and consistent view of its facts and circumstances and the applicable legal and economic principles. Each case should be decided on the basis of its own merits and, thus, the same principles may generate different results in different cases. The role of the competent authorities is to achieve a solution to the case which resolves the issue of potential double taxation and not to merely attempt to find the most advantageous resolution from the revenue point of view. Flexibility may be needed to achieve an appropriate compromise in a given case.

### **3.3 Audit settlements should not require the taxpayer to relinquish subsequent recourse to a MAP (United Nations Guide to the MAP, paragraph 80)**

In some jurisdictions, it is often a practice to include in an audit settlement an agreement by the taxpayer not to seek MAP relief after the settlement. In effect, two parties, the taxpayer and one tax administration, thus exclude the other tax administration from a consideration of the case. This may lead to double taxation and the development of inappropriate principles on the basis of which cases are settled, causing in the long run a system in which cooperation in the appropriate resolution of international double taxation is impeded.

### **3.4 Separation of the MAP and audit functions (United Nations Guide to the MAP, paragraph 62)**

While there are many ways to organize a MAP function which fit within the overall structure of the tax administration, it has been found to be desirable to separate the MAP and audit and assessment functions. It is important that the MAP function be independent and objective, with a focus on applying the treaty and relieving international double taxation. This requires a somewhat different “mind-set” from an auditor, whose principal job focus and relation to the taxpayer

tend to be somewhat different. The criteria for assessing a successful MAP function should be in terms of the time to resolve cases, and the achievement of principled and objective outcomes and not, for example, the amount of revenue collected.

### **3.5 Liberal use of the MAP under Article 25 (3) (MEMAP, Best Practice 1)**

While, in practice, most MAP activity involves taxpayer-initiated MAP seeking relief from taxation not in accordance with the treaty, it is also important that the competent authorities take full advantage of the authority they have, under Article 25 (3) of the United Nations Model Convention, to issue guidance and interpretations of general application. This can help avoid unnecessary disputes later over such matters in the context of a concrete case and allows taxpayers to better organize their affairs.

## **4. Arbitration under Article 25 (5)**

### **4.1 Introduction**

Article 25 (2) of both the United Nations and OECD Model Conventions establishes that, when presented with a taxpayer-initiated MAP request, the obligation of the competent authorities is that they “shall endeavour” to resolve the case under the MAP. While the competent authorities will make every effort to resolve the case on a principled basis, and while the majority of cases in practice will be resolved, there will inevitably be some in which, after good faith efforts, no agreement will be reached. As a result, unless there can be a consistent resolution of the case in the domestic courts of the countries involved, there will be unrelieved double taxation and one of the principal purposes of the treaty will not be fulfilled. In response to this problem, in 2010, the OECD Model Convention introduced paragraph 5 of Article 25 which provides that where the competent authorities have not been able to resolve a MAP case within two years of its presentation to one of them, the issues which are preventing them from reaching an agreement will be submitted to an independent arbitration board. The board will resolve the issues involved and then, under the OECD procedure,

the competent authorities will proceed to arrive at a MAP which will ensure that taxation is carried out in accordance with the treaty. The details of the OECD procedure and its relation to the United Nations Model Convention are discussed below, but it is important to observe at the outset that the arbitration procedure outlined in the OECD Model Convention is not in any sense an alternative to the MAP, rather it provides a mechanism for supplementing it and allowing it to more effectively perform its functions.

#### **4.2 Arbitration and the United Nations Model Convention**

The pros and cons of arbitration were discussed at length by the United Nations Committee of Experts on International Cooperation in Tax Matters and the United Nations Model Convention contains two versions of Article 25, alternative A, which does not contain an arbitration provision, and alternative B, which contains an arbitration provision which is modelled on, but differs from, the OECD Model Convention. Since this issue is of great importance to developing countries considering whether or not to include some form of arbitration in their treaties, it is useful to examine at some length the considerations that the Committee articulated.<sup>20</sup>

“The decision whether to agree in a bilateral convention on a mutual agreement procedure without mandatory arbitration as in alternative A or with mandatory arbitration as in alternative B depends on policy and administrative considerations of each Contracting State and its actual experiences with mutual agreement procedures. Countries should in advance analyze the advantages and disadvantages of mandatory or voluntary arbitration (see paragraph below) and evaluate whether or not arbitration is appropriate for them. Countries having limited experience with mutual agreement procedures could have difficulties to determine the consequences of adding arbitration in a mutual agreement procedure. Those countries could simply decide to refuse arbitration at this stage. They could, however, also include

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<sup>20</sup>Paragraphs 3-5 of the Commentary on Article 25 of the United Nations Model Convention.

arbitration but postpone its entry into force until each country has notified the other that the provision should become effective. Those countries could also decide that despite their lack of experience they are willing to add arbitration in a mutual agreement procedure in order to give certainty to taxpayers that a case presented under paragraph 1 of Article 25 will be solved through mutual agreement unless a taxpayer rejects the mutual agreement.

Members of the Committee in favour of alternative A pointed mainly to the following considerations and arguments:

- only a small number of cases are submitted to the mutual agreement procedure under paragraphs 1 and 2 of Article 25 and very few of them remain unresolved;
- domestic legal remedies can resolve the few cases that the competent authorities are not able to resolve through the mutual agreement procedure;
- due to the lack of expertise in many developing countries with mutual agreement procedures, arbitration would be unfair to those countries when the dispute occurs with more experienced countries;
- the interests of countries, which are so fundamental to their public policy, could hardly be safeguarded by private arbitrators in tax matters; arbitrators cannot be expected to make up for the lack of expertise in many developing countries;
- the neutrality and independence of possible arbitrators appears difficult to guarantee;
- it is very difficult to find experienced arbitrators;
- mandatory arbitration is costly and therefore not suitable for developing countries and countries in transition;
- it is not in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

Members of the Committee in favour of alternative B pointed mainly to the following considerations and arguments:

- despite the fact that only a small number of cases remain unresolved, each of these cases represents a situation where there is no resolution for a case where one competent authority considers that there is taxation not in accordance with the Convention and where there may be significant double taxation;
- arbitration provides more certainty to taxpayers that their cases can be resolved under the mutual agreement procedure and contributes to cross-border investment;
- domestic remedies may not resolve adequately and rapidly disputes concerning the application of bilateral conventions (risks of inconsistent court decisions in both countries and of unilateral interpretation of the Convention based on domestic law);
- the obligation to submit unresolved cases to arbitration after a given period of time may facilitate the endeavours of the competent authorities to reach an agreement within that period of time;
- on the basis of the experience under the EU Arbitration Convention, the effective recourse to mandatory arbitration should be rather unusual and the costs relating to that mechanism should be low; moreover, as arbitration provides more certainty to the taxpayers, it reduces the number of costly “protective” appeals and uncertain domestic proceedings;
- arbitrators have to reach a well-founded and impartial decision; consequently, they can adjust for the levels of expertise of countries and overcome the possible lack of experience of some countries;
- skilled and impartial arbitrators do exist from various backgrounds (government officials, judges, academics and practitioners) and from various regions (including from developing countries);

- it is in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.”

Thus, each country must consider the factors outlined above in developing its own approach to arbitration. In some cases, national law, policy or constitutional provisions may raise questions as to the ability of the State to enter into treaties which contain an arbitration provision, and these factors must be considered as well.

Since the introduction of the OECD provision in 2010, a growing number of countries, including developing countries, have been including some form of arbitration clause in their treaties and this increased experience should also be taken into consideration. Some treaties which have no arbitration clause require that if the treaty partner enters into a treaty with another partner which does have an arbitration clause, then that issue must be reopened in the existing treaty without further formalities being required.

#### **4.3 Differences between the OECD and United Nations versions of Article 25 (5)**

Before considering in detail the provisions of Article 25 (5) (alternative B) in the United Nations Model Convention, it is useful to point out some important differences between the OECD and United Nations approaches. While they both aim at obtaining a final resolution of the MAP, they differ in important ways. In general, the United Nations approach leaves more power in the hands of the competent authorities, but this is at the expense of ensuring that a MAP will ultimately be achieved.

##### **4.3.1 Period in which the competent authorities must resolve a MAP case**

In the OECD Model Convention, if the competent authorities have not reached an agreement within two years of the initial presentation of the case by the taxpayer, the issues which are preventing resolution must be presented to the arbitration process. The United Nations Model Convention provides for a three-year period.

#### **4.3.2 Who submits the case to arbitration?**

Under the OECD approach, it is the taxpayer who has the right to require that the unresolved issues in the case must be submitted to arbitration. In the United Nations version, the case is submitted to arbitration if one competent authority wishes to have the case arbitrated. Thus, if both competent authorities do not want to have the case go forward to arbitration, they can prevent a final resolution of the case and it will go undecided and result in double taxation. In this regard, the United Nations procedure is, from the point of view of the taxpayer, not truly mandatory.

#### **4.3.3 Finality of decision**

Under the OECD Model Convention, once the arbitration decision has been reached and communicated to the competent authorities, they are required to follow the decision and reach a MAP. Under the United Nations provision, modelled on a similar provision in the European Union Arbitration Convention, the competent authorities can deviate from the decision of the arbitrators if they can reach an agreement within six months of the arbitration agreement. Thus, they are still required to reach an agreement, but it can differ in result from the agreement which would have been based on the arbitration decision.

#### **4.3.4. Form of decision**

Both the United Nations and OECD Model Conventions have published a Sample Mutual Agreement on Arbitration (Sample Agreement), which sets out many of the technical and procedural aspects of the arbitration procedure. Under the OECD approach, the “default” or generally applicable rule is that the arbitrators must give a reasoned opinion for their decision. There is an alternative “streamlined” form of decision which is based on the so-called “last best offer” or “baseball” approach, under which each competent authority submits its desired result and the arbitrator simply picks one or the other of the two options without any reasoned opinion justifying the result. In the United Nations Sample Agreement, the “last best offer” approach is the base rule, although the competent authority can elect to use the “independent” format.

#### **4.4 Basic features of the United Nations arbitration provision**

##### **4.4.1 Supplementary dispute resolution**

As mentioned above, the basic function of Article 25 (2) is to ensure that the MAP comes to a satisfactory conclusion and eliminates taxation which is not in accordance with the views of the two competent authorities as to the proper interpretation and application of the treaty. It does not represent a “free standing” alternative dispute resolution procedure. The end result of the proceeding under Article 25 (5) of the United Nations Model Convention is an agreement to which the normally applicable MAP principles apply. It is no different than an agreement which was arrived at without the introduction of arbitration. In a sense, the whole MAP itself is already an alternative to the uncoordinated resolution of the dispute in the domestic courts. The procedural requirements which are developed in the Article and the accompanying Annex must be understood in this light.

##### **4.4.2 Time limits for requesting submission to arbitration**

Article 25 (5) of the United Nations Model Convention provides that a request that any unresolved issues be submitted to arbitration cannot be made until three years after the presentation of the case by the taxpayer requesting MAP relief. The request can be made at any time after the three-year period has past, that is to say, the competent authority who may want to initiate the arbitration procedure may wait beyond the three-year period to see if a MAP can be achieved through the usual means. It should be remembered (see section 2.2 above) that the taxpayer can request a MAP as soon as he believes that an action of one of the States “will result” in taxation not in accordance with the treaty. When a request has been made in these circumstances, there is no right at this point to request arbitration. The three-year period, which must run before arbitration can be requested, only commences after the taxpayer has presented a case that the actions of one of the States have in fact resulted in inappropriate taxation.

#### **4.4.3 Relation between arbitration and domestic legal proceedings**

Article 25 (5) of both the United Nations and OECD Model Conventions expressly excludes from arbitration any issue on which a court or administrative tribunal in either State has already given a decision. This restriction is necessary because, in most countries, the competent authorities are not in a position to effectively overrule a court decision. In such a situation, the competent authorities would not be in a position to implement a MAP based on an arbitration decision which deviated from the court decision. In countries where the competent authorities can deviate from a court decision in a MAP, this restriction may not be included in the text of Article 25.

With respect to ongoing domestic legal proceedings involving the issues in dispute, many States allow the proceedings to be suspended if a MAP is requested and then require the taxpayer to terminate the domestic procedures as a condition of accepting the MAP resolution of the case (see section 2.6.1). The same approach should be taken with respect to an agreement which has been reached by means of an arbitration of unresolved issues. After arbitration, the taxpayer would be required to waive any existing claims under domestic legal proceedings and the accepted agreement would then be binding on both competent authorities and the taxpayer. Of course, for countries which require the waiver of domestic legal remedies as a condition for accepting a MAP request, the issue will not arise.

### **4.5 Procedural aspects of arbitration under Article 25 (alternative B)**

#### **4.5.1 General**

There are no procedural requirements in Article 25 (5) (alternative B) of the United Nations Model Convention other than the requirement that the unresolved issues be submitted for arbitration after the three-year period following the presentation of the case. Instead, it is provided that the competent authorities shall settle the “mode of application” of this provision by mutual agreement. A Sample Agreement setting out a number of procedural rules is attached as an Annex to the Commentary on Article 25 (5) (alternative B). In general, it is similar

to the Sample Agreement used in the OECD Model Convention, but, as mentioned above in section 4.3.4, the United Nations Sample Agreement uses the “last best offer” approach as the basic format for the proceedings, though the competent authorities can agree to use an “independent opinion” approach. In addition, it provides for a *de minimis* amount below which arbitration would not be available and also requires appointed arbitrators to certify their independence and impartiality.

#### **4.5.1. The request for arbitration**

Where the competent authorities have not been able to reach an agreement to resolve a case within three years from the time the case was presented by the taxpayer, one of them has the right to request that the unresolved issues be submitted to arbitration. This referral of unresolved issues to arbitration is mandatory and does not depend on prior agreement of the other competent authority. As indicated above, the function of arbitration in Article 25 is not to decide the case itself, but only the issues that are preventing the competent authorities from coming to a mutual agreement. The introduction of arbitration enables the mutual agreement procedure to reach a satisfactory resolution of the case, which is being blocked by the failure to agree on certain issues.

#### **4.5.2 Terms of Reference**

The Terms of Reference establish the jurisdictional base for the arbitration process and set out the issues to be decided in the arbitral process. The competent authorities are required to establish the Terms of Reference within three months of the request for arbitration.<sup>21</sup> The Terms of Reference may also provide additional procedural rules to govern the arbitration process. The Terms of Reference are to be communicated to the person who has presented the case, who would presumably have been consulted on their formulation.

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<sup>21</sup>Paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 2 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention, quoting paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

#### 4.5.3 Appointment of arbitrators

After the Terms of Reference have been established and communicated to the person who has presented the case, the competent authorities have three months to each appoint an arbitrator.<sup>22</sup> The Sample Agreement does not set out any special qualifications for the arbitrators, on the assumption that all of the parties will be interested in appointing qualified persons. Government officials may be appointed as long as the official was not directly involved in prior stages of the case. As a default rule to deal with the situation where one of the competent authorities has not made a timely appointment, the Sample Agreement gives authority to the Chair of the United Nations Committee of Experts on International Cooperation in Tax Matters to make the appointment.<sup>23</sup> After their appointment, the two designated arbitrators have two months to appoint a third arbitrator, who will function as the chair of the arbitral panel. Again as a default mechanism, if the arbitrators are unable to appoint a chair, the Chair of the United Nations Committee of Experts on International Cooperation in Tax Matters can fill that position. The arbitrators may develop whatever procedural or evidentiary rules they deem necessary beyond those established in the Terms of Reference. Information provided to the arbitrators will be subject to the same confidentiality requirements as are normally applicable to the competent authorities. The bilateral agreement will set the compensation of the arbitrators and the arbitrators to be appointed will be required to certify that there are no circumstances which might give rise to any doubts as to their independence or impartiality.<sup>24</sup>

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<sup>22</sup>Paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 2 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention, quoting paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

<sup>23</sup>Paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 2 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention, quoting paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

<sup>24</sup>Paragraph 1 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention.

#### **4.5.4 Participation of the taxpayer**

The arbitration foreseen in Article 25 (5) is structured as an extension of the mutual agreement procedure. As this is basically a government-to-government procedure aimed at a consistent application of the treaty, the taxpayer's right to participate in the process is correspondingly limited. Thus, the Sample Agreement provides that the taxpayer shall have the same rights to present its case in writing to the arbitrators as it would have in a MAP. The Sample Agreement does foresee, however, that, with the permission of the arbitrators, an oral presentation may be made. This limited degree of participation is consistent with the fact that the taxpayer, at the conclusion of the proceeding, has the right to reject the final agreement which is based on the arbitral decision. The process of reaching a decision is basically up to the competent authorities.

#### **4.5.5 The arbitral decision**

As indicated above, the United Nations version of the Sample Agreement takes as its default position for the arbitral procedure the so-called "last best offer" approach. Under this approach, each competent authority makes a proposal for the resolution of the issue in dispute to the arbitral board and the board chooses one or the other of those proposals. The arbitrators are given only a limited time to make the decision and do not give a full written explanation of the decision but only "short reasons" explaining the choice.<sup>25</sup> The United Nations Committee of Experts on International Cooperation in Tax Matters selected this approach as it is quicker and less costly. However, the Terms of Reference may allow the competent authorities to select an "independent opinion" if they wish. This approach has the advantage of providing a fuller explanation of the decision and gives the possibility for the decision being a guide to the settlement of future cases involving the same issue. If an independent opinion approach is taken, it would also be possible, with the approval of both the competent authorities and the taxpayer to publish a redacted version of the decision. This too would help resolve cases in the future.

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<sup>25</sup>See paragraph 6 of the Sample Agreement included under paragraph 2 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention.

#### 4.5.6 Implementation of the decision

After the arbitration procedure has resolved the issues which were preventing the issuance of an agreement, the case is returned to the competent authorities. Under the United Nations Model Convention, after the decision has been communicated to the competent authorities, they still have a six-month period in which they can agree to a different solution than that arrived at by the arbitration panel, as long as that solution comes to a common understanding of the application and interpretation of the convention.

#### 4.5.7 Costs

The Sample Agreement stipulates that, in general, each competent authority will bear its own costs in relation to the arbitration. Thus each competent authority will bear the costs of the arbitrator which it has appointed. The costs of the third arbitrator and other general costs can be shared equally. The Sample Agreement also recognizes that when there is a significant disparity in the level of development of the two States it may be possible to agree on other methods of allocation of costs.<sup>26</sup>

#### 4.5.8 “Voluntary” arbitration

In some cases, countries may not be ready to commit themselves to the mandatory type of arbitration described above which permits one competent authority to force the resolution of a case by arbitration. In such situations, a country may wish nonetheless to include a provision for so-called “voluntary” arbitration under which, if a case has not been resolved after a certain period, both the competent authorities and the taxpayer may agree that the case be submitted for arbitration. This procedure gives more control to the competent authorities over the types of issues which will be submitted for arbitration. However, this procedure fails to ensure that a case will ultimately be resolved, which is the basic function of the arbitration provision. In addition, experience with this type of arbitration clause in the past has indicated that it has not been effective to move cases to resolution.

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<sup>26</sup>Paragraph 32 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention.

## **Annex: examples and analyses of MAP cases**

### **Example 1: Article 5/Article 7 MAP case**

#### **Scenario A**

Company R, a resident of State R, carries on a business in State R and State S. In the year in question, it made a total profit of 100 and reported all of the profit to State R and none to State S. State S subsequently assessed a tax on 25 of the profits of Company R, asserting that the profits were attributable to business activities of Company R in State S. As a result of the assessment, Company R is potentially subject to “juridical” double taxation on the 25 of profit by State R and State S. Within three years of the assessment of the State S tax, Company R files a claim for MAP relief with State R, its State of residence, claiming that it is being taxed “not in accordance with the convention” as provided in Article 25, since its business activities in State S were “preparatory or auxiliary” and thus did not constitute a permanent establishment under Article 5 (4) (e). The competent authority of State R accepts the claim under Article 25 (1) finding it justified; it has been filed within three years of the notification of the charge, Company R has provided all of the relevant information as to its activities in State S and there are no other indications as to why the case should not be accepted.

On examination of the facts of the case, State R finds that it cannot resolve the case unilaterally and contacts the competent authority of State S. It presents its position to State S, outlining its view of the facts and the law and its reason for coming to the conclusions. After negotiations, and exchanges of position papers, State S and State R agree that Company R does not have a permanent establishment in State S and agree in a MAP setting forth that conclusion.

#### **Scenario B**

The facts are the same as in scenario A above, but after negotiations the competent authorities find that Company R does have a permanent establishment in State S, but disagree as to the amount of income to be attributed to the State S permanent establishment. They request

additional information from the taxpayer as to the functions carried out in State S, the assets involved there and the risks assumed. After additional negotiations, they enter into a MAP that State S is entitled to tax 15 of profits. The taxpayer has the choice of either accepting the MAP and the allocation of profits agreed by the competent authorities or, if it has appropriately secured its rights to judicial remedies in State S, to attempt to obtain a judicial determination in State S that there was no permanent establishment or that less profit should be allocated to State S. Assuming that Company R prefers to accept the MAP, it must waive any rights to further legal remedies in State R and State S. Company R would then be entitled to a refund of tax from State R on the 15 of profit already taxed there and would have a tax liability on the 15 of profits not reported in State S. Depending on the domestic rules of State R and State S, Company R would owe interest on the liability in State S and be entitled to interest on the refund from State R. The MAP may have been able to deal with the interest issues as well.

### **Scenario C**

The facts are the same as in scenario B above, except three years have passed since Company R has presented its case and the competent authorities of State R and State S have still not been able to resolve the case. If the treaty between Country R and Country S followed alternative B of Article 25 of the United Nations Model Convention, one of the competent authorities could request that the unresolved issues in the case could be submitted to arbitration, assuming that there is no prior decision by the courts or administrative authorities of either State in the case.

### **Example 2: Article 9 MAP case**

Company R in State R produces cars at a cost of 100 and sells them to Company S, a wholly-owned State S subsidiary organized in State S, at a price of 150, declaring and paying tax on a profit of 50 in Country R. Company S buys the cars for 150 and sells them for 175, declaring a profit and paying tax on 25 to State S. Country S audits Company S and proposes to adjust the price that S paid for the cars to 125 on

the basis of Article 9 of the relevant treaty, claiming that the transfer price of 150 was not at arm's length. The treaty between Country S and Country R follows the United Nations Model Convention and contains Article 9 (2). As a result, there is economic double taxation, as 25 of profit is being taxed both in State R and State S, though to different taxpayers.

Company R could make a claim under Article 25 (1) of the United Nations Model Convention and make a request to State R to make a "corresponding" or "correlative" adjustment reducing its profits by 25, corresponding to the "primary" adjustment made by State S in the profits of Company S. If Country R agreed with the Country S determination of the transfer price, it could make a unilateral resolution of the case.

However, State R is only required to make a unilateral corresponding adjustment if it finds that the Country S primary adjustment was "justified both in principle and as regards amount". Assuming that Country R does not agree with the determination of the transfer price by Country S, it would then begin the process of bilateral negotiations described in section 2.5 above.

Assuming that Country S and Country R agree after negotiations that the appropriate transfer price was 135 and that Company R and Company S agreed with that result, an agreement to that effect could be implemented by reducing the tax of Company R and correspondingly increasing the tax on Company S. The agreement may also treat the question of interest in both States. However, after this adjustment, Company R still has received 15 too much cash from Company S. It may be possible to structure a "secondary" adjustment, which would allow the return of the excess funds to Company S on a tax neutral basis.

## Chapter IX

### Exchange of information

DIANE M. RING\*

#### 1. Introduction

Exchange of tax information has become one of the most commonly discussed and promoted features of the international tax system. In recent years, the G20 has encouraged countries to pursue increased exchange of tax information and has directed international organizations to coordinate and facilitate this effort. In April 2013, the G20 welcomed the “progress made towards automatic exchange of information which is expected to be the standard and urged all jurisdictions to move towards exchanging information automatically with their treaty partners, as appropriate.”<sup>1</sup> Similarly, in June 2013, the G8 issued a communiqué also advocating multilateral automatic exchange as a “new single global standard” and emphasizing that “[i]t is important that all jurisdictions, including developing countries, benefit from this new standard in information exchange.”<sup>2</sup> In recognition of the constraints faced by developing countries, this communiqué called on the OECD “to work to ensure that the relevant systems and processes are as accessible as possible to enable all countries to implement this new standard.”<sup>3</sup> Given the pervasive attention to information exchange this is no longer a topic of interest to a limited number of jurisdictions. All countries and their national level tax officials must have a solid understanding of the broad context of the information exchange

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<sup>1</sup>Communiqué, Meeting of Finance Ministers and Central Bank Governors, Washington, 18-19 April 2013, available at <http://g20.org/documents>.

<sup>2</sup>G8 Leaders Communiqué, 2013 Lough Erne, paragraph 26 (18 June 2013), available at <http://www.whitehouse.gov/the-press-office/2013/06/18/g-8-leaders-communiqué>, or at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/207771/Lough\\_Erne\\_2013\\_G8\\_Leaders\\_Communique.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207771/Lough_Erne_2013_G8_Leaders_Communique.pdf).

<sup>3</sup>*Ibid.*

discussion and practice, a working knowledge of the various mechanisms of information exchange, and an appreciation of the issues and concerns that may be of particular interest to developing countries. Moreover, developing countries need to consider what is necessary for them to comply with their obligation to exchange information, how exchange of information may be beneficial to their own jurisdictions, and what features of such an agreement are most critical for them.

At its broadest level, information exchange refers to the exchange of tax information (either taxpayer-specific information, or more general tax-related information) by one country to another, to aid the requesting jurisdiction<sup>4</sup> in implementing and administering its tax laws. Exchange of information can only take place pursuant to an existing agreement between the two jurisdictions (such as, but not limited to, a bilateral double tax treaty) that contains a provision authorizing the exchange of information. Beyond this basic description of information exchange are many details crucial to the functioning and scope of an exchange of information provision. As discussed in this chapter, there are model agreements and provisions available to serve as a starting point for countries seeking to negotiate an agreement to provide for information exchange. However, countries should be sensitive to the range of variations in such provisions. The commentaries accompanying the different models provide a good source for reviewing and assessing much of this potential variation.

## **2. Overview of information exchange**

### **2.1 Core features**

A review of information exchange can be roughly divided into three core features: (a) the legal framework under which exchange of information will take place (the terms of the agreement and the rights and responsibilities of the signatories); (b) a country's domestic infrastructure relevant to information exchange (legal, regulatory,

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<sup>4</sup>In this chapter, the country asking another country for information is referred to as the "requesting State" and the country that is asked to provide the information is referred to as the "requested State."

administrative, and technical); and (c) compliance/implementation of the agreement. All countries should think carefully and explicitly about these three elements, both from their own perspective and that of the other contracting State, in assessing the net effect of their participation in exchange of information. The basic, current, international standard for exchange of information calls for information exchange (pursuant to an agreement) upon request, where the information will be foreseeably relevant for the administration or assessment of taxes of the requesting State. Information must be exchanged regardless of bank secrecy rules and regardless of whether the requested State (the State which is asked to provide information) has a domestic interest in the information being sought. Although the current standard references information exchange “on request,” it is critical to observe that the strong trend for the future is towards automatic exchange of information, as urged by the G8 and the G20 (see section 1), and as reflected in the OECD’s report on information exchange presented at the G8 summit in June 2013.<sup>5</sup>

### **2.1.1 Legal framework**

As noted in section 1, information exchange must take place within the context of an agreement between the two States. If there is no such agreement in place between two countries, exchange of information cannot occur. As discussed in section 2.3, there are several kinds of agreements that can serve as the basis for an exchange of information. These agreements may be either bilateral or multilateral. They have many similarities in their basic structure and purpose with regard to information exchange, but there are important differences which are discussed in section 2.3, and in sections 5.1-5.4. All of the agreements, however, detail the rights and responsibilities of the signatories (for example, when and how information can be obtained, when and how information must be provided). Specifically, these agreements determine: (a) what types of taxes are covered by the agreement (that is

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<sup>5</sup>OECD, “A Step Change in Tax Transparency,” June 2013, paragraph 5 (a report prepared at the request of the G8 to “analyse how jurisdictions can build on recent increases in bilateral automatic exchange agreements to efficiently implement automatic exchange of financial account information ... in a multilateral context”).

to say, for which taxes can information be exchanged to assist in the administration and enforcement of tax laws); (b) for which taxpayers can information be requested/received; (c) how a decision to exchange information is made (that is to say, on the basis of a request by one country, through an automatic exchange process, or spontaneously by the country having the information); (d) what information a State requesting it must provide in order to be able to secure an exchange under the agreement; (e) in what form will information be transmitted; (f) what duties does the requested State have to search for information that is not readily available; (g) under what circumstances can a country refuse to exchange information when a request is made pursuant to an applicable agreement; (h) what are the limits on the requesting State's use of the information; (i) what are the duties of the requesting State regarding the information received (that is to say, duties to protect privacy); and (j) who bears the costs of securing and transmitting information.

The decisions made regarding each of these items directly shape the operation and output of any agreement providing for exchange of information. An agreement can promote robust and active exchange of information, or it can make exchange of information unlikely and difficult to achieve. An agreement can have a comprehensive scope, aiding broadly in tax enforcement, or a much more narrow scope, targeting only a limited class of tax issues.

### **2.1.2 Domestic infrastructure**

Just as important as the actual agreement under which exchange of information would take place is the domestic infrastructure of each country. This infrastructure, broadly understood to include the domestic legal framework, the domestic non-tax regulatory structure, the administrative parts of the tax system, and the technical capacity of the tax authority and the taxpayers, will affect a country's ability, willingness and capacity to comply with any commitment to exchange information. Part of the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes<sup>6</sup> has been to examine

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<sup>6</sup>Further information regarding the Global Forum and its work is available at <http://www.oecd.org/tax/transparency/>.

the domestic infrastructure of jurisdictions and assess the degree to which they are compatible with an effective exchange of information and, if not, what changes would be recommended. Three examples can illustrate this point.

First, if a country has domestic rules requiring bank secrecy, it cannot fulfil its obligations under the typical modern agreement that requires exchange of information regardless of domestic regulations, law, practices or requirements grounded in bank secrecy. The country will need to implement domestic level changes in its bank secrecy rules in order to effectively participate under an agreement providing for meaningful information exchange. Second, if a country does not currently have domestic rules and procedures in place to protect taxpayer information, the development of such rules and procedures will be essential to meeting the country's duties under any agreement to safeguard tax information received from another State. Third, depending on a State's current level of experience, technology, staffing and expertise in its tax administrative offices, there may be some difficulty in acquiring, organizing, sharing and making use of taxpayer information. A variety of resources (including those offered by international organizations) are directed at helping countries build their tax administration capacity so that they can be more effective in the management of their entire tax system, including their ability to exchange information and receive information in a productive manner.

### **2.1.3 Compliance with/implementation of an agreement to exchange information**

Ultimately, entering into agreements to exchange tax information has little impact if the exchange provisions are not used, or if requests for information are routinely discouraged, either directly or indirectly (for example, through delay, poor quality data, or baseless challenges to requests). States should consider whether they and their partners under the agreements are committed to the process and goals of information exchange. This commitment will be reflected in how the exchange provisions of the agreement are drafted, in how States seek to ensure that they are domestically able to perform under the agreement and, ultimately, through experience with actual requests.

## 2.2 Major issues

Several key issues run throughout the three major components of information exchange described above (legal framework, domestic infrastructure, and compliance with/implementation of an agreement to exchange information). Because of the pervasive influence and importance of these key issues, it is useful to identify them separately. They are: (a) confidentiality regarding taxpayer information; (b) meaningful commitment and participation; (c) realistic ability to meet responsibilities under the agreement; (d) realistic ability to enforce rights under the agreement and effectively use information received; and (e) responsibility for costs under the agreement. Although the meaning of some of these issues may be clear, it is valuable to briefly note their specific relevance to the practice of exchange of information, because they shape much of the debate, design and policy.

### 2.2.1 Confidentiality

Historically, confidentiality has been a major concern regarding information exchange. States have resisted pursuing agreements with jurisdictions that fail to provide adequate legal structure and administrative practice supporting the duty to treat the information as private, to limit those who have access to the information and to limit the purposes for which the information is used.

### 2.2.2 Meaningful commitment

The question of “meaningful” commitment is reflected in the language of the Commentary on Article 26, Exchange of information, of the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>7</sup> (United Nations Model Convention). Paragraph 9 of the Commentary, for example, highlights the obligation undertaken by States pursuant to Article 26 to engage in “effective” exchange of information. The paragraph notes that States may not avoid their Article 26 obligations “through unreasonable time

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<sup>7</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange.”

### **2.2.3 Realistic capacity**

There can be an absence of effective information exchange through less intentional barriers, including the administrative limits of a country’s domestic tax system and tax administration. The Commentary on Article 26 of the United Nations Model Convention provides that a developed country may not “refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country.”<sup>8</sup>

### **2.2.4 Realistic ability to benefit**

Developing countries in particular may be concerned about their ability to benefit from an agreement that includes information exchange. It will be important for such countries to bear this point in mind when negotiating agreements and when seeking to improve domestic tax administrative capacity.

### **2.2.5 Cost and balance**

Compliance with exchange of information requests is not costless. In a double tax treaty, States typically consider the relative balance between the two contracting States of both the individual provisions and the treaty as a whole. With respect to a provision on exchange of information, if the requests for information are generally balanced, the cost dimension is a less prominent issue. But where there is a likely imbalance of requests (for example, one State making many more requests for information than the other) and/or where one of the contracting States has more limited administrative capacity, the question of cost or burden becomes relevant. This situation is more likely in the context of an agreement between a developed and a developing country. States can respond to this risk in making design choices about their exchange

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<sup>8</sup>Paragraph 1.3 of the Commentary on Article 26 of the United Nations Model Convention.

of information provision and in developing a stronger infrastructure (which could enhance both the ability to provide information and the ability to use information).

### **2.3 Options for information exchange**

Although an agreement between the two States seeking to exchange information is a necessary predicate for the exchange of information, there are several different legal mechanisms available. First, bilateral double tax treaties typically have an exchange of information provision (such as Article 26 of the United Nations Model Convention). It is important to carefully review the terms of older bilateral double treaties. Provisions drafted years ago may not contain some of the key language seen today that seeks to ensure more effective exchange of information. For example, older provisions may not be as clear on whether a jurisdiction can rely on a domestic bank secrecy rule to refuse to comply with a request for information.

Second, bilateral Tax Information Exchange Agreements (TIEAs) can also serve as the legal basis for information exchange. It is very important to be clear about the limited scope of TIEAs. Unlike bilateral double tax treaties, TIEAs only address exchange of information. They do not cover the other subjects typically found in a double tax treaty. TIEAs are examined in further detail in section 5.2.

Third, a variety of multilateral agreements can also support information exchange. Such multilateral agreements include the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (discussed in section 5.3) and various regional multilateral agreements (discussed in section 5.4).

## **3. Contemporary context of information exchange**

Any State considering exchange of information (whether through bilateral double tax treaties, TIEAs or other agreements) should do so with an understanding of the current tax, political and commercial context in which these provisions are now being negotiated and implemented. In order to understand the background of Article 26 of the United Nations Model Convention, which is the principal focus of this

chapter, it is necessary to review the background against which this Article and its Commentary was developed.

Exchange of information provisions are not new. Such articles have been included in model double tax treaties and bilateral double tax treaties for decades.<sup>9</sup> But the events of the late 2000s created an entirely new context and backdrop for discussions about exchange of information. Since then there has been a proliferation of stand-alone agreements for exchange of information (that is to say, TIEAs).<sup>10</sup> Not only has attention been directed to the existence of agreements for exchange of information (stand-alone or as part of treaties), but there has been increased attention to the reality of information exchange. This latter analysis has considered the details (legal, practical, technological and policy-related) that are crucial in moving from an “agreement” to exchange information, to the actual exchange of relevant and useful information in a timely fashion. The Global Forum on Transparency and Exchange of Information for Tax Purposes (through its peer review process) examines a country’s meaningful commitment to exchange of information and to the operational issues surrounding it (that is to say, the request format, data gathering and transmission and identification of taxpayers). Recent activity regarding exchange of information (including the work of the Global Forum and the rise of TIEAs) cannot be fully understood without an appreciation of the major developments in tax policy of the past decade and of the major reputational crises that triggered a re-framing of the conversation regarding exchange of information.

### **3.1 Tax competition work and the development of a model TIEA**

During the 1990s, cross-border tax competition became a major topic of international tax debate. A number of jurisdictions expressed concern

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<sup>9</sup>Exchange of information has its roots in the 1927 League of Nations draft of a Bilateral Convention on Administrative Assistance in Matters of Taxation. Thus, as noted in section 2.3, older treaties typically have exchange of information provisions, although their scope and terms may differ significantly from more contemporary versions.

<sup>10</sup>TIEAs are examined in section 5.2.

that other countries were engaging in tax competition — using rules and features of their tax system to attract business and/or flows of capital through their jurisdiction. One of the big questions at the time was when and, under what circumstances, this competitive effort was “inappropriate.” In 1998, the Organisation for Economic Co-operation and Development (OECD) released a report, entitled “Harmful Tax Competition: An Emerging Global Issue.” In part, the report sought to distinguish “harmful” competitive measures from those that would be “acceptable” forms of competition (such as the decision by a jurisdiction to impose tax at a low rate on a comprehensive base of income). Among the four factors that the OECD report highlighted as evidence of harmful tax competition was lack of information exchange. Specifically the report stated:

“The ability or willingness of a country to provide information to other countries is a key factor in deciding upon whether the effect of a regime operated by that country has the potential to cause harmful effects. A country may be constrained in exchanging information, for the purpose of the application of a tax treaty as well as for the application of national legislation, because of secrecy laws which prevent the tax authorities from obtaining information for other countries on taxpayers benefiting from the operation of a preferential tax regime. In addition, even where there are no formal secrecy laws, administrative policies or practices may impede the exchange of information. For example, the country may determine as a matter of administrative policy that certain transactions or relations between an enterprise and its customers are a business secret which need not be disclosed under Article 26 paragraph 2 (c) of the OECD Model Tax Convention, or the country with the preferential tax regime may simply be uncooperative with other countries in providing information. Such laws, administrative policies, practices or lack of co-operation may suggest that the preferential tax regime constitutes harmful tax competition.”<sup>11</sup>

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<sup>11</sup>OECD, *Harmful Tax Competition: An Emerging Global Issue*, paragraph 64 (1998).

The report continued on to discuss the impact of bank secrecy practices and rules on the effective exchange of information:

“The limited access that certain countries have to bank information for tax purposes (*e.g.*, because of bank secrecy rules) is increasingly inadequate to detect and to prevent the abuse of harmful preferential tax regimes by taxpayers. The Committee has commissioned a survey of country practices regarding access to bank information for tax purposes.”<sup>12</sup>

The report concluded with a range of recommendations (unilateral, bilateral and multilateral) for countries seeking to curb the effects of harmful tax competition. Among these recommendations<sup>13</sup> were suggestions for stronger exchange of information rules and practices.<sup>14</sup> Not surprisingly, the OECD report generated controversy. In part as a response to some of those challenges, the OECD directed increasing attention to exchange of information over the next few years. In 2002, the OECD released a Model Agreement on Exchange of Information on Tax Matters intended to provide a framework for exchange of information with “tax haven” jurisdictions or other countries with which a bilateral double tax treaty was not in force. Over the next few years some TIEAs were signed, but not a large number.

### **3.2 The “withholding tax” alternative to exchange of information**

At the same time that information issues were the focus of OECD attention, similar questions were debated in the European Union (EU). In 2001, the EU nations began working on a project to prevent EU resident taxpayers from hiding (and not reporting) their income from assets held outside their country of residence. Certainly, exchange of information was one possible solution to the problem of taxpayers who

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<sup>12</sup>Ibid., paragraph 65.

<sup>13</sup>The recommendations included stronger controlled foreign corporation rules and special rules for investment vehicles. OECD, *Harmful Tax Competition: An Emerging Global Issue*, paragraphs 96-100 and 103 (1998).

<sup>14</sup>Ibid., paragraphs 106-107, 112 and 114-117.

failed to report their income to their residence jurisdiction. However, objections to such exchange of information (grounded in part on bank secrecy laws) were raised by several States. The agreed solution which was provided by the 2003 EU Council Directive on taxation of savings income in the form of interest payments<sup>15</sup> allowed Austria, Belgium and Luxembourg to withhold tax for the residence jurisdiction instead of providing information to that jurisdiction. This option was to be available for a “transitional period”, on the acknowledgment that withholding is not an adequate substitute for information exchange, because it fails to ensure that the residence jurisdiction is aware of the principal amount in the account (which may never have been reported by the taxpayer).

### **3.3 The bank secrecy crisis and the rise of TIEAs**

Although some movement was taking place on exchange of information issues during the first half of the 2000s, the tenor of the conversation shifted dramatically in 2008 with the public eruption of a couple of very high-profile tax evasion scandals in Europe. These scandals changed the public perception of banking secrecy from one centered on financial privacy and security to one grounded in a picture of fraudulent (and often criminal) evasion of residence country taxation made possible by the banks’ concerted and knowing efforts.

In the years following these scandals, a dramatically increasing number of TIEAs have been signed. Fewer than 30 had been signed before the scandals; by 2012, over 500 had been signed, although the significance of the total numbers requires some scrutiny (some countries, frequently identified as “tax havens”, in fact, have signed TIEAs with other “tax havens”, rather than with major capital exporting jurisdictions). Relatedly, the Global Forum on Transparency and Exchange of Information for Tax Purposes (an evolution of an earlier OECD working group and forum activity, which now has approximately 120 members) began to engage in peer review of countries’ domestic rules and practices relevant to transparency and exchange of information.

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<sup>15</sup>Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, 3 June 2003.

## **4. Exchange of information under Article 26 of the United Nations Model Convention**

### **4.1 Introduction**

The purpose of Article 26 of the United Nations Model Convention is to provide an explicit framework (within the context of a bilateral double tax treaty) for the circumstances under which a treaty partner may request or receive information from the other partner, which would be useful or relevant in helping to administer or enforce the requesting country's domestic tax rules or treaty terms. Although Article 26 has been modified as recently as 2011 to provide increased clarity on certain points, its accompanying Commentary is invaluable in providing additional details, examples, and alternative language.

#### **4.1.1 Reasons for exchanging information**

Before considering the details of the double tax treaty's exchange of information regime, it is important to be clear about why countries might want to exchange information. This knowledge would be relevant in both evaluating their commitment to the process, as well as the kinds of information that they would want to be able to effectively secure and use. The exchange of information process can provide countries with access to information regarding the assets, accounts and income of their taxpayers held in another jurisdiction. Such information is especially valuable when those taxpayers have not reported the income, or information, domestically, as otherwise required. Although this use of exchanged information may be most prominent today given the banking scandals, there are a variety of other contexts in which States may seek information to more effectively implement their own tax laws. A country may seek to verify whether deductions sought by the taxpayer against domestic taxation are valid. Alternatively, a requesting State may be trying to determine whether a taxpayer is in fact a resident of the treaty partner, or owns certain entities or assets, or is meaningfully engaged in a transaction such that the country should respect the transaction as reported by the taxpayer. Any information on these points could significantly alter the tax treatment that the requesting State would consider appropriate under its laws.

Interest in information exchange is not limited to developed economies. Given current estimates regarding the amount (and percentage) of household wealth of many developing countries held offshore, these countries may find exchange of information essential in addressing both capital flight and tax evasion. Additionally, many developing countries are home to the operations of multinational enterprises (MNEs) which may be engaging in transfer pricing. According to the United Nations Conference on Trade and Development (UNCTAD), in 2012 global foreign direct investment flows “to developing economies, for the first time ever, exceeded those to developed countries, by some US\$130 billion.”<sup>16</sup> Valuable information about an MNE’s activities and financial flows with related parties, as well as industry-wide data, may be available in a treaty partner jurisdiction. Exchange of information provisions give the developing country access to that data.

For many States, the Value Added Tax (VAT) is an important part of the tax base. Exchange of information provisions that reach the VAT (as, for example, Article 26 of the United Nations Model Convention does) assist a jurisdiction in combating VAT carousel fraud<sup>17</sup> (by, for example, verifying input credits claimed by its resident

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<sup>16</sup>*Global Investment Trends Monitor*, No. 11, 23 January 2013, United Nations Conference on Trade and Development.

<sup>17</sup>Carousel fraud is one version of missing trader intra-Community (MITC) fraud. In a simple case of carousel fraud, for example, Taxpayer A in Country A transfers goods to Taxpayer B in Country B. The goods are zero-rated coming out of Country A, thus Taxpayer B does not pay VAT. Taxpayer B then transfers the goods to Taxpayer C (also in country B) and collects VAT on that transfer to C. However, Taxpayer B does not transmit the collected VAT to Country B, and “disappears” with the money it collected. Subsequently, C transfers the goods back to Taxpayer A in another zero-rated transaction (hence the circularity of a “carousel”) and Taxpayer C claims credit for the VAT it paid. Thus, Country B, which credits a VAT that it did not collect, loses on the circular transaction. Carousel fraud is discussed more extensively in OECD Forum on Tax Administration, “Tax Repayments: Maintaining the Balance Between Refund Service Delivery, Compliance and Integrity,” (May 2011) available at <http://www.oecd.org/ctp/administration/48384654.pdf>. Additional discussion and analysis can be found in Financial Action Task Force, “Laundering the Proceeds of VAT Carousel Fraud,” (23 February 2007) (noting its findings of carousel fraud

taxpayer). States may also benefit from requesting non-taxpayer specific information, as they seek to better understand the audit process for a particular industry, or as they seek to understand new tax avoidance and evasion schemes.<sup>18</sup> Paragraphs 10.1 and 10.2 of the Commentary on Article 26 of the United Nations Model Convention provide many examples of situations in which a State might request information to assist in administering and enforcing its tax laws. These examples are not exclusive, but they offer a developing country an opportunity to consider the full range of circumstances in which it might find the ability to request information valuable for its own tax administration.

Finally, the existence of an information exchange provision or agreement may facilitate an enhanced enforcement relationship between the two States which may offer developing countries both the potential to streamline some of their auditing work, as well as the opportunity to gain exposure to a range of audit processes and issues. The two versions of this enhanced relationship are simultaneous audit and joint audit.

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outside of the EU, including examples in Mexico and Ukraine) available at <http://www.fatf-gafi.org/media/fatf/documents/reports/Laundering%20the%20Proceeds%20of%20VAT%20Caroussel%20Fraud.pdf>.

<sup>18</sup>For example, information exchange forms a central part of the work of the Joint International Tax Shelter Information Centre (JITSIC). JITSIC is a limited member organization directed at sharing information (through the double tax treaty networks of the JITSIC members) regarding new and emerging tax shelters. JITSIC was formed in 2004, based on a Memorandum of Understanding among the four founding States (namely, Australia, Canada, United Kingdom of Great Britain and Northern Ireland and the United States of America). Five additional States joined thereafter (namely, China, France, Germany, Japan and the Republic of South Korea). The central idea of JITSIC is to serve as an organization for the tax administration in each Member State to come together and share information with a goal of identifying and stopping tax avoidance. Information exchange is handled through the mechanisms imbedded in the members' bilateral treaties. Member States can assist each other by sharing information regarding both specific issues they are seeing with their taxpayers, as well as broader patterns, trends or strategies. Sharing information of this type enables jurisdictions to become aware of new schemes earlier and to target more effectively their examinations of taxpayers. Other jurisdictions, including developing countries, could establish similar networks, perhaps on a regional basis.

(a) Simultaneous audit:

A growing source of information for States regarding taxpayers is the simultaneous audit. In its Manual on the Implementation of Exchange of Information Provisions for Tax Purposes, the OECD states:

“A simultaneous tax examination is an arrangement by two or more countries to examine simultaneously and independently, each on its territory, the tax affairs of taxpayers (or a taxpayer) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain. ... As a compliance and control tool used by tax administrations, simultaneous tax examinations are effective in cases where international tax avoidance and evasion is suspected. The examination can relate to both direct and indirect taxes. They assist in revealing exploitation or abuse of existing laws and procedures in individual countries. ... Simultaneous tax examinations may reduce the compliance burden for taxpayers by co-ordinating enquiries from different States’ tax authorities and avoiding duplication. They can also play a role in averting double taxation and thus prevent the need to subsequently resort to a mutual agreement procedure under a provision similar to Article 25 of the OECD Model Tax Convention.”<sup>19</sup>

A number of countries have engaged in simultaneous audits to date. It is useful to note that simultaneous examinations/audits are different from joint audits. In the case of the former, the audits themselves are separate and taxpayers may share different stories with the different tax authorities involved. The “coordination” dimension of simultaneous examinations derives from countries working together on their information requests and gathering.

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<sup>19</sup>OECD, Manual on the Implementation of Exchange of Information Provisions for Tax Purposes, Module 5, Simultaneous Tax Examinations (January 2006), available at <http://www.oecd.org/ctp/exchange-of-tax-information/36648057.pdf>.

## (b) Joint audit:

In the case of a joint audit, the audit itself is a single process performed jointly by the participating States. It requires a different level of cooperation and engagement. Additionally, practical details, such as the determination of a taxable year, must be resolved to make a joint audit feasible. As a result, joint audits are not currently common, but countries are expressing increased interest in developing and expanding their use. The OECD describes a joint audit as follows:

“A **joint audit** can be described as two or more countries joining together to form a single audit team to examine an issue(s)/transaction(s) of one or more related taxable persons (both legal entities and individuals) with cross-border business activities, perhaps including cross-border transactions involving related affiliated companies organized in the participating countries, and in which the countries have a common or complementary interest; where the taxpayer jointly makes presentations and shares information with the countries, and the team includes Competent Authority representatives from each country. A joint audit can be activated for all compliance activities that can be accommodated through ... the competent authority process outlined in the tax treaties between the participating revenue bodies.”<sup>20</sup>

As discussed in section 2.1.1, to the extent that a country has an interest in obtaining information from other States, it is necessary to have either a bilateral double tax treaty with a provision comparable to Article 26, or to have entered into a TIEA, or appropriate multilateral agreement. Without such an agreement in place to provide the framework for the request, the request will be denied.<sup>21</sup>

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<sup>20</sup>OECD, Forum on Tax Administration, Joint Audit Report (September 2010), available at <http://www.oecd.org/tax/administration/45988932.pdf>.

<sup>21</sup>For example, on 23 January 2011, Liechtenstein denied the request of Indian tax authorities for certain information regarding assets of Indian taxpayers reportedly held in the country. Liechtenstein based its denial on the

#### 4.1.2 Expectations of information exchange under Article 26

The Commentary on Article 26 of the United Nations Model Convention is explicit in establishing the tenor for how the provision is to be interpreted and applied. The goal is two-fold: to make the scope of information exchange broad<sup>22</sup> and effective. In 2011, Article 26 (1) was revised to provide that “[t]he competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of domestic laws of the Contracting States.”<sup>23</sup> Having the “right” to certain information without an exchange mechanism that is effective (that is to say, one that ensures that the correct information is retrieved and delivered in a timely fashion and in an accessible format) is almost useless. Although the Commentary to Article 26 offers some alternative language for the phrase “foreseeably relevant”, these options are intended to allow partners to select language that they perceive as being clear in identifying the goal of effective exchange of information.

#### 4.2 Operation of exchange under Article 26

Article 26 of the United Nations Model Convention has six paragraphs that seek to outline the key elements of information exchange: the duty to exchange, the duty to protect the information received, the grounds upon which a request to exchange may be declined, and the grounds which do not constitute an appropriate basis for refusal to exchange. Although these details are explored below, it should be stressed that the 2011 changes to Article 26 were primarily designed to clarify the intended scope of the provisions. Among these changes was the addition of Article 26 (5) of the United Nations Model Convention

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absence of any treaty or TIEA which could serve as the legal foundation for compliance with the request. See, Randall Jackson, “Liechtenstein Refuses to Share Info with India,” 61 Tax Notes International 336 (31 January 2011). On March 28, 2013, Liechtenstein and India signed a TIEA effective for taxable years beginning on or after 1 April 2013.

<sup>22</sup>Paragraph 1 of the Commentary on Article 26 of the United Nations Model Convention states that this Article “embodies rules under which information may be exchanged to the widest possible extent”.

<sup>23</sup>The phrase “foreseeably relevant” replaced the earlier term “necessary.”

which bars bank secrecy from serving as a justification for refusal to exchange information. As the Commentary to Article 26 of the Model Convention suggests, countries may have differing views on whether these 2011 changes to that Article are substantive or interpretive.

#### **4.2.1 The basic questions of information exchange**

As was reviewed in section 2.1.1, provisions such as Article 26 of the United Nations Model Convention provide all the legal details underlying the exchange process. But there are four basic questions that set the contours of exchange of information: (a) Who can request information? (b) About whom can information be requested? (c) What information can be requested? (d) With respect to which taxes can information be requested? The language of both Article 26 and the Commentary are clear on these points. The competent authorities of the two contracting States serve as the points of communication for information exchange. Thus, it is the competent authority of a requesting State which communicates the request — and this request is communicated to the competent authority of the requested State. Furthermore, the two competent authorities, pursuant to Article 26 (6) of the United Nations Model Convention, can together agree upon “methods and techniques” regarding the actual exchange of information.

The next important question concerns about whom information can be sought. Paragraph 8.2 of the Commentary on Article 26 of the United Nations Model Convention explicitly states that the subject of the information request need not be a resident or a person engaged in economic activity in the requested State. One example in the Commentary is particularly interesting in light of the recent focus on tax evasion and offshore bank accounts. Paragraph 8.2 of the Commentary on Article 26 of the United Nations Model Convention offers as an example of an appropriate request one in which the requesting State seeks information regarding a bank account held in the requested State by a person who is not a resident of either the requested State or the requesting State. Thus, information exchange is not limited to information regarding persons covered by Article 1 of the treaty.

The third basic question, regarding the type of information that can be requested, was the subject of some of the 2011 changes to Article

26. In 2011, language in Article 26 (1) was changed from information that was “necessary” for carrying out the provisions of the treaty or the administration of domestic law to information that is “foreseeably relevant” for those purposes. The explicit purpose of the current language is to clarify that the requesting State need not demonstrate its need for the information before the requested State has a duty to provide it. This 2011 change is characterized in the Commentary as one that is not substantive, but rather serves to “remove doubts” and “clarify” the prior language.<sup>24</sup>

The Commentary also gives concrete examples of the type of data that can be requested, specifically noting that it need not be taxpayer-specific data. These examples are illuminating given the role of tax and finance professionals in facilitating certain evasion. The Commentary notes that States may exchange information regarding “aggressive or abusive tax avoidance schemes, such as those promoted by some international accounting firms”.<sup>25</sup> The other major example involves the provision of industry-wide data, such as information regarding the oil, fishing, pharmaceutical, or banking sector more generally.<sup>26</sup> This example supports the efforts among some countries to explore tax evasion and avoidance strategies that may be unique to a particular economic sector. As countries seek to be effective in countering tax evasion, they need to be aware of, and share information regarding, the newest patterns and practices of tax evasion that groups of taxpayers are undertaking. As observed in section 4.1, one formalized example of this effort is the Joint International Tax Shelter Information Centre (JITSIC) — a group of nine countries (Australia, Canada, China, France, Germany, Japan, the Republic of South Korea, the United Kingdom of Great Britain and Northern Ireland and the United States of America). Part of the mission of JITSIC is to coordinate and share information (including information about novel tax shelters) with a goal of curbing tax avoidance. Similar arrangements would be possible among developing countries.

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<sup>24</sup>Paragraph 4 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>25</sup>Paragraph 7.3 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>26</sup>Paragraph 7.3 of the Commentary on Article 26 of the United Nations Model Convention.

The fourth question concerns the type of taxes covered (that is to say, the taxes for which an information request can be made). As with the question of who is covered, the question of the taxes covered by an Article 26 request is broader than the list of taxes that are usually the subject of the double tax treaty. Thus, a State can not only request information relevant to the application of the treaty itself, or to domestic taxes identified in Article 2, but also request information pertinent to all other domestic taxes (including subnational taxes).<sup>27</sup> The drafting option provided by the Commentary for this part of Article 26 (1) reflects the reality that the otherwise broad scope of taxes covered may be either burdensome or legally difficult for some States. In such cases, the Commentary provides for alternative language that limits the covered taxes to the Convention itself and to other taxes listed by the contracting States.<sup>28</sup>

#### **4.2.2 Examples of information that could be exchanged pursuant to Article 26**

##### **(a) Financial intermediaries:**

A financial intermediary (FI) invests the money of its account holders in State A, which requires recordkeeping regarding beneficial ownership, but does not regularly request those records for domestic law enforcement. State B suspects that some beneficiaries of the account holders of the FI are State B residents. State B may request State A to obtain information on identified taxpayers from the FI.<sup>29</sup>

##### **(b) Non-resident foreign subsidiaries:**

A resident of State A has subsidiaries located in State B and State C. State B believes that the State B subsidiary has been skimming or shifting profits into the State C subsidiary. State B may

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<sup>27</sup>Article 26 (1) and paragraph 8 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>28</sup>Paragraph 8.1 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>29</sup>Paragraph 10.2 (e) of the Commentary on Article 26 of the United Nations Model Convention.

request that State A provide information regarding the profits and expenses of the State C subsidiary. Domestic law of State A obliges a parent company to keep records of foreign subsidiary transactions.<sup>30</sup>

(c) Entity classification:

State A seeks to impose a corporate tax on an entity that is claiming partnership status. State A may request information from State B that would be helpful to State A in appropriately classifying the entity. Such information could include the manner in which the entity is classified for State B tax purposes.<sup>31</sup>

(d) Exempt income:

A resident of State A holds a bank account in State B. The income is exempt from tax in State B under domestic law. State A may request that State B provide information regarding the amount of income (interest) earned on the account.<sup>32</sup>

#### **4.2.3 Objections to exchanging information — Appropriate grounds**

Every State which is signatory to a double tax treaty must determine the answers to the following questions: what are appropriate grounds for refusing to comply with a request? And, conversely, what are not appropriate grounds for refusal? The response of Article 26 and the Commentary to these questions reflects an effort to take into consideration the practical, legal and administrative concerns of the requested State along with the mission of Article 26 to provide effective information exchange. The ultimate goal is to enable the treaty and domestic tax laws to be properly applied and enforced. The discussion in the Commentary regarding grounds for objecting to an information

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<sup>30</sup>Paragraph 10.2 (f) of the Commentary on Article 26 of the United Nations Model Convention.

<sup>31</sup>Paragraph 10.1 (g) of the Commentary on Article 26 of the United Nations Model Convention.

<sup>32</sup>Paragraph 10.2 (d) of the Commentary on Article 26 of the United Nations Model Convention.

request should be considered against the backdrop of experience with Article 26 in practice. In particular, countries have relied on a variety of arguments, including bank or financial secrecy, to reject a request for information.

Article 26 (3) itself includes three basic subparagraphs noting circumstances under which compliance with a request is not required: (a) where compliance is “at variance with the laws and administrative practice” of the requested or requesting State; (b) where information is “not obtainable under the laws or in the ordinary course of the administration” of the requested or requesting State; and (c) where compliance would disclose trade secrets etc., or be contrary to public policy. The Commentary is important in providing the necessary context for the meaning and scope of these exceptions, how they should be applied and the range of contexts in which exchange cannot be refused.

First, a State may refuse to provide the information in the specific form requested if that form is not “known or permitted under its law or administrative practice.”<sup>33</sup> However, to limit the use of this objection, the Commentary confirms that refusing to comply with a request to provide information in a particular form does not excuse the requested State from providing the information at all.

The next aspect dealt with is particularly nuanced. States are not required to provide information if compliance with the request would create a conflict with domestic law or administrative practice.<sup>34</sup> Without further limitation, this exception could significantly curtail valuable information exchange, especially information exchange targeting the kinds of evasion and abuse reflected in the banking scandals from 2008 onward. For example, without more in the treaty, it would appear that a domestic bank secrecy law would trump a request for information regarding accounts held in the requested State. Thus, in 2011, as described below, Article 26 was revised to state that certain domestic laws could not be used as a defense to decline information exchange requests.

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<sup>33</sup>Paragraph 5.1 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>34</sup>Article 26 (3) (a) and (b) of the United Nations Model Convention.

What then would be appropriate circumstances in which a State could decline to provide information because of a domestic law/administrative practice conflict? An example of appropriate refusal on the grounds of conflict with domestic law may be the case where, under its own laws, the requested State is not permitted to seize private papers from a taxpayer without court permission. The requested State need not perform a seizure without court permission to meet a treaty information request — even if the requesting State could seize papers without court permission in its own country.<sup>35</sup>

States can also refuse to provide information if complying with such a request would effectively allow the requesting State to avoid limitations imposed by its own law and government. Essentially, a requesting State cannot use a request to circumvent its own laws. That said, minor differences in law and administrative practice do not rise to the level of circumvention. The core question is whether the requesting State would be able to adequately respond to a comparable request and provide similar information (even if the procedures or steps were slightly different).<sup>36</sup>

One important version of grounds for refusal to exchange information is the “confidential communications” exception. This exception covers communications such as those between an attorney and client that are protected under domestic law. However, it does not cover documents or records delivered to a legal representative, nor does it cover communications if the legal representative participated in a plan to commit tax evasion or avoidance.<sup>37</sup> To the extent that States are concerned that the 2011 changes to Article 26 regarding bank secrecy (discussed further below) might hamper a State’s legitimate efforts to protect attorney client privilege, the Commentary offers a drafting option. States can add language to Article 26 (5) expressly providing

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<sup>35</sup>Article 26 (3) (a) and (b) of the United Nations Model Convention; paragraph 16 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>36</sup>Article 26 (3) (a) and (b) of the United Nations Model Convention; paragraphs 18 and 18.1 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>37</sup>Paragraphs 21.2, 21.3 and 27.6 of the Commentary on Article 26 of the United Nations Model Convention.

that genuine attorney-client communications will be protected from an information exchange request where they would otherwise be protected under the requested State's law.<sup>38</sup>

The Commentary advises States that the “trade secrets” exception in Article 26 (3) (c) should not be construed broadly, because that would conflict with the core vision of Article 26. Thus, a State should not refrain from providing, or decline to disclose, information because this might be embarrassing, generate bad publicity or increase taxes. Nor does the trade secrets exception generally cover financial information. Furthermore, the status of information as “secret” is not, in itself, a bar to disclosure. A State may disclose secret information if the requested State concludes that disclosure to the public or competitors is unlikely because of the confidentiality provision in Article 26 (2), which places a duty on the requesting State to protect information received and use it only in certain ways.<sup>39</sup>

#### **4.2.4 Objections to exchanging information — Inappropriate grounds**

Article 26 and its Commentary not only seek to clarify what are good reasons for declining to provide information, but they also seek to clarify those which are not. The most prominent change in this regard is the new language in Article 26 (5), introduced in 2011. Under this language, States are barred from relying on bank secrecy to decline to provide information. Thus, Article 26 (5) operates as an override to Article 26 (3), to the extent that bank secrecy was the justification offered under Article 26 (3). For some States, this change to Article 26 will be an important and substantive one.<sup>40</sup>

An example of inappropriate refusal to exchange information on the grounds of bank secrecy may occur where a taxpayer subject to tax in State A has a bank account with a bank in State B and State A — in

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<sup>38</sup>Paragraph 27.7 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>39</sup>Paragraphs 22.1, 22.2 and 22.3 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>40</sup>Paragraphs 4.1, 27.2 and 27.3 of the Commentary on Article 26 of the United Nations Model Convention.

the context of examining the taxpayer's individual return — requests that State B provide “all bank account income and asset information” held by the bank. State B cannot refuse on the grounds of its bank secrecy laws and should comply with the request.<sup>41</sup>

Similarly, Article 26 is also quite explicit about the invalidity of another argument against exchanging information — that the information concerns a person not resident in either contracting State. Article 26 (1) clearly rejects this possible argument.

One issue that has emerged in the context of refusal to provide information is the importance and role of criminal conduct in either State. As a baseline, Article 26 does not require criminality — that is to say, a requesting State may seek information even if the information does not pertain to a crime under its laws. Thus, for example, a State may request information regarding a taxpayer in the context of a civil (that is to say, non-criminal) investigation of that taxpayer. The Commentary provides a drafting option for those contracting States that wish to require a requesting State to be investigating a criminal matter before that State can seek information. However, even that drafting option makes explicit that only criminality in the requesting State is relevant. Under no circumstances is it necessary or relevant that the conduct be criminal in the requested State. This distinction is important because prior experience with Article 26 has revealed significant differences among jurisdictions in their views of what constitutes a tax crime. Under some bilateral tax treaties, States have refused to provide information on the grounds that the conduct being examined is not a crime under the requested State's domestic law.

Perhaps not surprisingly, given the broad scope of taxes for which information can be requested under Article 26, the Commentary confirms that a State may not decline to provide information on the grounds that it does not implement that kind of tax. For example, if State A makes a request for information to State B that would be useful in enforcing State A's value added tax, State B could not refuse to comply because it does not impose a value added tax.<sup>42</sup>

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<sup>41</sup>Paragraph 28 (b) of the Commentary on Article 26 of the United Nations Model Convention.

<sup>42</sup>Paragraph 16.2 of the Commentary on Article 26 of the United Nations Model Convention.

Finally, Article 26 (4) is explicit in providing that a State cannot decline to provide information on the grounds that it has no use for that information. This 2011 addition to the United Nations Model Convention was, according to the Commentary, taken directly from the OECD Model Convention.<sup>43</sup> The Commentary notes a concern that some contracting States might argue that they are not legally capable of providing information that they do not themselves need for tax purposes (despite the language in Article 26 (4)). As a response to this concern, the Commentary provides alternative treaty language. This alternative wording explicitly requires that each contracting State must undertake to ensure, through legislation, rulemaking or administrative steps, that its competent authority will have adequate powers under domestic law to secure information for treaty exchange purposes.<sup>44</sup>

#### 4.2.5 Data protection

Not surprisingly, if States are surrendering information on taxpayers to another jurisdiction, they may have some interest in ensuring how that information will be used and disseminated. What are these States concerned about? Risks range from “benign” business concerns (that the information will be made available to competitors of the taxpayers) to more serious abuses (that the tax and financial information will be used to facilitate criminal conduct and/or threaten or harass the taxpayer). Article 26 (2) speaks directly to data protection, requiring the requesting State to treat the information received as confidential in the same manner it does with information secured domestically. Furthermore, the Article provides additional specificity by limiting disclosure of the received information only to persons “concerned with the assessment or collection of, the enforcement or prosecution ... or oversight” of the taxes enumerated in Article 1. These persons to whom information has been disclosed under the treaty may use the information solely for these tax related purposes. The treaty language in Article 26 (2) does contemplate disclosure of the exchanged

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<sup>43</sup>Paragraph 26 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>44</sup>Paragraph 26.3 of the Commentary on Article 26 of the United Nations Model Convention.

information in “public court proceedings or in judicial decisions”. The Commentary identifies several points upon which States may seek to clarify the language in their treaty, either for purposes of restricting the scope of Article 26 (2) or expanding its use. Specifically, States may wish to: (a) object, in the bilateral treaty, to exchanged information being made public by courts; (b) allow expressly, in the bilateral treaty, for exchanged information to be shared with a third country; or (c) provide a mechanism for allowing the exchanged information to be used by the requesting State for other purposes. It should also be anticipated that the details surrounding the technical mechanisms by which information is exchanged and delivered (for example, by electronic data systems) will be developed by the competent authorities with attention to data protection issues.<sup>45</sup>

#### **4.2.6 How information can be exchanged**

One central operating question regarding information exchange is how this exchange process will take place. Much of the real effect of a treaty’s information exchange provision turns on the implementation choices made under the treaty and under the competent authority negotiations on the details of information exchange. As an initial matter, Article 26 (6) of the United Nations Model Convention directs the competent authorities to develop jointly the methods and techniques for information exchange. This provision does not appear in the OECD Model Convention directly, but it is presumed.

There are three basic ways to exchange information: (a) on request; (b) routine/automatic exchange; and (c) spontaneous exchange. The language of Article 26 clearly contemplates information exchange “on request” at a minimum. For example, Article 26 (4) begins with the language: “[i]f information is requested by a contracting State”. Recognizing that information exchange would at least cover this category, but might not extend to the other two, the Commentary provides alternative language to add to the end of Article 26 (6). This language would clarify that the contracting States were agreeing to exchange on request, and also to automatic and spontaneous exchanges as

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<sup>45</sup>Paragraphs 5.2, 12.2, 13.2 and 13.3 of the Commentary on Article 26 of the United Nations Model Convention.

established by the competent authorities.<sup>46</sup> As indicated above in sections 1 and 2.1, there is a strong movement toward making greater use of automatic exchange, which is rapidly becoming the international standard. This is an important factor for developing countries to keep in mind in structuring treaty and domestic law exchange provisions.

As both the United Nations Model Convention and countries' treaty practices continue to encourage meaningful exchange of information, a serious concern arises regarding burdens imposed on the requested State, particularly when that State is a developing country. Compliance with a request or series of requests may be burdensome, at least relative to the tax administration's capacity in the requested State. The Commentary recognizes this risk:

"Some members of the Committee have expressed a concern that information requests from a developed country to a developing country could place excessive burdens on the tax department in the developing country due to the different capacity of their tax administrations to obtain and provide information. That concern might be alleviated by making the requesting State responsible for material extraordinary costs associated with a request for information. In this context, the question of whether an extraordinary cost of obtaining requested information is material could be determined not by reference to some absolute amount but by reference to the cost relative to the total budget of the tax department being asked to provide information."<sup>47</sup>

The Commentary offers optional treaty language for Article 26 (6) which would allow for shifting certain costs of providing information from the requested State to the requesting State:

"Extraordinary costs incurred in providing information shall be borne by the Contracting Party which

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<sup>46</sup>Paragraphs 29.2 and 30 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>47</sup>Paragraph 29.3 of the Commentary on Article 26 of the United Nations Model Convention.

requests the information. The competent authorities of the Contracting Parties shall consult with each other in advance if the costs of providing information with respect to the specific request are expected to be extraordinary.”<sup>48</sup>

Although the Commentary does not provide an example of cost shifting, such a scenario could include the following. Assume that State A, a developed country, makes a request under Article 26 of its bilateral double tax treaty with State B for information regarding certain taxpayers. State B, a developing country, incurs extraordinary costs in satisfying this request, including: (a) reasonable fees charged by third party experts to assist in meeting the request, and (b) litigation costs incurred by State B in responding to legal challenges initiated by financial entities in State B in possession of data pertinent to State A’s request. State B, pursuant to the additional language in Article 26 of its treaty with State A (and as further elaborated by any memoranda of understanding negotiated by the competent authorities) requests reimbursement from State A for these extraordinary costs.

The current Commentary on Article 26 of the United Nations Model Convention includes paragraphs 6-25 of the former Commentary on Article 26. These additional paragraphs provide a more detailed examination of: (a) the three mechanisms of exchange; (b) multiple country arrangements (that is to say, special procedures for cases in which three countries are all part of a treaty network); (c) a practice of regular consultation between the competent authorities to review and resolve exchange of information questions; and (d) transmittal mechanisms. These additional paragraphs can provide a foundation for the discussions between competent authorities on implementation of Article 26.<sup>49</sup> Ultimately, a successful programme of information exchange will depend upon mechanical details, such as compatible electronic systems of exchange and universal taxpayer identification, as well as the inputs (that is to say, both the quality and the volume of data involved).

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<sup>48</sup>Paragraph 29.4 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>49</sup>Paragraph 30 of the Commentary on Article 26 of the United Nations Model Convention.

On a very practical level, to participate in information exchange and other administrative provisions under the treaty, a State must designate who in its government (typically in the tax administration) will serve as its “competent authority”. The competent authority is the State’s representative working with its treaty partner in implementing the treaty, including the exchange of information provision. Typically, a request for information will not originate with the competent authority. Rather, someone in the tax administration (such as a tax auditor or examiner) will initiate the request. Each State will design its own domestic process for moving a request from the initial field level up to the competent authority. It is then the competent authority of the requesting State who makes the request to the competent authority of the requested State. The competent authority of the requested State will work through its own internal domestic processes to confirm that the request is appropriate under the treaty, then secure the information and, ultimately, transmit it to the requesting State’s competent authority (who will then send the information to the appropriate tax officials who initiated the request). The competent authorities from the two contracting States may enter into a memorandum of understanding (MOU) to establish in greater detail the process for making requests and providing information under the exchange of information provision.

#### **4.3 Comparison to the OECD Model Convention**

It is both valuable and inevitable that a discussion of the United Nations Model Convention will invite comparison to the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>50</sup> (OECD Model Convention). There is, of course, significant overlap across the entirety of both Model Conventions, and within Article 26 itself of each of them. The OECD Commentary on Article 26 is generally considered to be “relevant” in the interpretation of Article 26 of the United Nations Model Convention.<sup>51</sup>

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<sup>50</sup>Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (loose-leaf).

<sup>51</sup>Paragraphs 1.2 and 7.2 of the Commentary on Article 26 of the United Nations Model Convention.

A few of the differences between the United Nations and the OECD Model Conventions should be observed.

(a) Scope and purpose of exchange of information:

Article 26 of the United Nations Model Convention was revised in 2011 to explicitly state that information would be exchanged to help prevent “avoidance or evasion of ... taxes.” The difference between avoidance and evasion has been a point of contention between some treaty partners in applying information exchange provisions. The language of Article 26 of the United Nations Model Convention was intended to clarify what existed in the Commentary—that addressing both problems is an appropriate goal for States and an appropriate role for exchange of information. Although the Commentary on Article 26 of the OECD Model Convention similarly identifies both avoidance and evasion as proper targets of State action, Article 26 of the OECD Model Convention does not have that explicit language.

(b) Type of information exchanged:

According to the Commentaries on Article 26 of both the United Nations and OECD Model Conventions, information exchange is not restricted to “taxpayer specific information”. Thus, information may be exchanged regarding abusive tax schemes, economic sectors or tax administration. One interesting point to note at this stage is that language was added to the OECD Commentary in July 2012<sup>52</sup> that allows “group identification” for an information exchange request. The United Nations Committee of Experts on International Cooperation in Tax Matters is currently considering exchange of information regarding groups of taxpayers and the related concern over “fishing expeditions”. A request for information regarding a “group” of taxpayers who are not individually named and identified has traditionally been viewed as problematic by some countries who fear that the exchange of information process

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<sup>52</sup>As a technical matter, these changes are now part of the OECD Model Convention. However, they will not be published until the next update to the OECD Model Convention and Commentary is released (likely in 2014).

could be used for “fishing expeditions” — to hunt for information without any specific or clear idea of a taxpayer that would be the target of the requesting State’s tax administration. The OECD has sought to formulate a position that articulates when and how group requests would be appropriate. The new 2012 OECD language quoted below may be useful in considering these questions:

“The standard of ‘foreseeable relevance’ can be met both in cases dealing with one taxpayer (whether identified by name or otherwise) or several taxpayers (whether identified by name or otherwise). Where a Contracting State undertakes an investigation into a particular group of taxpayers in accordance with its laws, any request related to the investigation will typically serve ‘the administration or enforcement’ of its domestic tax laws and thus comply with the requirements of paragraph 1, provided it meets the standard of ‘foreseeable relevance’. However, where the request relates to a group of taxpayers not individually identified, it will often be more difficult to establish that the request is not a fishing expedition, as the requesting State cannot point to an ongoing investigation into the affairs of a particular taxpayer which in most cases would by itself dispel the notion of the request being random or speculative. In such cases it is therefore necessary that the requesting State provide a detailed description of the group and the specific facts and circumstances that have led to the request, an explanation of the applicable law and why there is reason to believe that the taxpayers in the group for whom information is requested have been non-compliant with that law supported by a clear factual basis. It further requires a showing that the requested information would assist in determining compliance by the taxpayers in the group.”<sup>53</sup>

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<sup>53</sup>Paragraph 5.2 of the Commentary on Article 26 of the OECD Model Convention.

The potential for group identification could be very significant in making “on request” exchange of information more effective and meaningful. For example, in many cases, a requesting State may have reason to believe residents have unreported accounts (and income) at a financial institution in the treaty partner jurisdiction. However, the requesting State may not have specific identifying information on the resident taxpayers. The more specific the request must be to qualify under the treaty, the more limited the opportunities would be to use exchange of information on request to tackle such tax evasion. Automatic exchange, which is actively discussed among various countries and is strongly encouraged by the G20, could ultimately provide significant assistance in uncovering hidden accounts.

(c) Purposes for which requested information may be used:

Article 26 of the United Nations Model Convention provides that information secured through the information request process “shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the [covered] taxes ...”. That Article then continues stating that “[s]uch persons or authorities shall use the information only for such purposes.”<sup>54</sup> Article 26 (2) of the OECD Model Convention contained language virtually identical to the one of Article 26 (2) of the United Nations Model Convention until July 2012. Now, Article 26 (2) of the OECD Model Convention adds the following sentence at the end: “Notwithstanding the foregoing, the information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use”. This expanded OECD language previously appeared in the OECD Commentary as an option, and currently appears in paragraph 13.3 of the Commentary on Article 26 of the United Nations Model Convention, as an option.

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<sup>54</sup>Article 26 (2) of the United Nations Model Convention.

## 5. Other mechanisms for information exchange

### 5.1 Introduction

The increased attention to information exchange since 2002, and more specifically since 2008, has resulted in the growth of other mechanisms (that is to say, other legal agreements) by which information can be provided or exchanged. In addition to the exchange of information provisions in bilateral double tax treaties, there are two other major categories of agreements regarding exchange of information: (a) Tax Information Exchange Agreements (TIEAs); and (b) multilateral agreements, including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.<sup>55</sup> To some degree, TIEAs are the closest parallel to Article 26. In fact, one way to understand the role of TIEAs is to envision them as stand-alone agreements for exchange of information in cases in which the two States do not have (and may not have in the near future) a comprehensive bilateral tax treaty. Just because States do not have a full bilateral treaty does not mean that they would not have an interest in negotiating, and would not benefit from, an agreement exclusively addressing exchange of information. However, it is very important to acknowledge the limited scope of TIEAs. They only cover information exchange, and not the wide array of other topics found in a bilateral double tax treaty.

### 5.2 Tax Information Exchange Agreements

As discussed in section 3.1, the OECD released a Model Agreement on Exchange of Information on Tax Matters in 2002.<sup>56</sup> For the next few years following its release, there was relatively little interest in executing these agreements and in fact few were signed. During this period, the newly created Global Forum on Transparency and Exchange of Information for Tax Purposes, a body that grew out of the earlier OECD

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<sup>55</sup>OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf>.

<sup>56</sup>OECD, Agreement on Exchange of Information on Tax Matters, 2002, available at <http://www.oecd.org/ctp/exchange-of-tax-information/2082215.pdf>.

work on harmful tax competition, provided a venue for reviewing the transparency and information exchange practices of Forum members. The process of review, known as “peer review,” sought to provide a detailed assessment and report on the domestic law infrastructure and practices impacting transparency and information exchange.

Following the banking scandals of 2008 (see section 3.3), interest in executing TIEAs increased and the number of TIEAs signed grew exponentially. Although some were agreements between jurisdictions that have often been identified as tax havens, many of them were agreements for which one signatory State was likely to impose meaningful taxation on the basis of information received. TIEAs have many features in common with Article 26 of the United Nations Model Convention, including:

- (a) Exchange is mandatory (Article 26 (1) of the United Nations Model Convention; Article 5 (1) of the OECD Model Agreement on Exchange of Information on Tax Matters (OECD TIEA));
- (b) Requested States need not have a tax interest in the information (Article 26 (4) of the United Nations Model Convention; Article 5 (2) of the OECD TIEA);
- (c) Tax matters being pursued need not constitute a crime under the laws of the requested State (paragraph 25 of the Commentary on Article 26 of the United Nations Model Convention; paragraph 40 of the Commentary on Article 5 of the OECD TIEA);
- (d) Use of the language “foreseeably relevant” to characterize the type of information that would be subject to exchange (Article 26 (1) of the United Nations Model Convention; Articles 1 and 5 (5) of the OECD TIEA);
- (e) Bank secrecy cannot serve as reason not to exchange (Article 26 (5) of the United Nations Model Convention; Article 4 (a) of the OECD TIEA);
- (f) Confidentiality of exchanged information (Article 26 (2) of the United Nations Model Convention; Article 8 of the OECD TIEA);
- (g) A requested State need not obtain information that requesting State would not be able to obtain in similar

circumstances under domestic law (Article 26 (3) (b) of the United Nations Model Convention; paragraph 18 of the Commentary on Article 26 of the United Nations Model Convention; Article 7 (1) of the OECD TIEA; paragraph 72 of Commentary on Article 7 of the OECD TIEA);

- (h) Exception for trade secrets (Article 26 (3) (c) of the United Nations Model Convention; paragraph 18 of the Commentary on Article 26 of the United Nations Model Convention; Article 7 (1) of the OECD TIEA; paragraph 72 of the Commentary on Article 7 of the OECD TIEA);
- (i) Contracting States are allowed to agree to a cost structure for requests beyond the ordinary (paragraph 29.3 of the Commentary on Article 26 of the United Nations Model Convention; Article 9 of the OECD TIEA; paragraph 98 of the Commentary on Article 9 of the OECD TIEA); and
- (j) Coverage is not limited to residents of either contracting State (paragraph 2 of the Commentary on Article 26 of the United Nations Model Convention; paragraph 7 of the Commentary on Article 2 of the OECD TIEA).

However, there are some very significant differences between TIEAs and Article 26 in a bilateral double tax treaty:

- (a) The OECD TIEA is drafted for both bilateral and multilateral cases (not just bilateral);
- (b) The focus of the OECD TIEA is on “exchange upon request” and “does not cover automatic or spontaneous exchange of information”, although contracting States may agree to expand the coverage of their cooperation (paragraphs 29.1 and 29.2 of the Commentary on Article 26 of the United Nations Model Convention; paragraph 39 of the Commentary on Article 5 of the OECD TIEA);
- (c) The OECD TIEA covers specifically enumerated taxes only (Article 3 of the OECD TIEA; paragraphs 8 and 9 of the Commentary on Article 3 of the OECD TIEA; Article 26 (1) of the United Nations Model Convention; paragraphs 8 and 8.1 of the Commentary on Article 26 of the United Nations Model Convention);

- (d) The OECD TIEA is more detailed in identifying the type of information that the requesting State shall provide in making a request under the agreement (Article 5 (5) of the OECD TIEA).

TIEAs can be a viable alternative for States that do not already have a bilateral double tax treaty, and either do not intend to pursue one at this time, or are unlikely to reach agreement on the full range of topics covered by a bilateral double tax treaty at any point in the immediate future.

### **5.3 Multilateral Convention on Mutual Assistance in Tax Matters**

The other notable agreement available to States that includes information exchange is the Multilateral Convention on Mutual Administrative Assistance in Tax Matters<sup>57</sup> (Multilateral Convention). It was developed by the OECD and the Council of Europe in 1998 and subsequently amended in 2011. It is now open to all countries. Over 50 countries have now signed the Multilateral Convention, including a number of developing countries, for example, Azerbaijan, Costa Rica, Ghana and Morocco. At this point, a key factor in the ability to rely on this Multilateral Convention is whether a particular State has signed and ratified it, and whether the States from which the information is needed have also signed and ratified it. Additionally, it is important to note that individual signatories can make reservations to the basic terms of the Multilateral Convention; thus, the precise provisions of it may not fully capture what the exchange of information relationship with a specific jurisdiction would look like under it. Article 24 of the Multilateral Convention provides that signatories' competent authorities will establish the rules and procedures for implementing it as between two signatory States. The scope of the Multilateral Convention extends beyond information exchange to include forms of administrative assistance, including assistance in tax collection and simultaneous audits.

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<sup>57</sup>OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf>.

With respect to the information exchange portion of the Multilateral Convention, key similarities to Article 26 of the United Nations Model Convention include:

- (a) Mandatory exchange (Article 26 (1) of the United Nations Model Convention; Article 4 (1) of the Multilateral Convention; paragraph 49 of the Revised Explanatory Report to the Multilateral Convention);
- (b) The exchange covers both taxpayer-specific information and information that is relevant to tax administration and compliance improvement, to risk analysis and to tax avoidance and evasion schemes (paragraph 7.3 of the Commentary on Article 26 of the United Nations Model Convention; paragraph 54 of the Revised Explanatory Report to the Multilateral Convention);
- (c) Use of the language “foreseeably relevant” for the type of information that would be subject to exchange (paragraphs 7-7.3 of the Commentary on Article 26 of the United Nations Model Convention; Article 4 (1) of the Multilateral Convention; paragraph 49 of the Revised Explanatory Report to the Multilateral Convention); and
- (d) Covers exchange on request, automatic exchange and spontaneous exchange of information (paragraphs 29.1-29.3 of the Commentary on Article 26 of the United Nations Model Convention; Articles, 5-7 of the Multilateral Convention; paragraphs 57-71 of the Revised Explanatory Report to the Multilateral Convention).<sup>58</sup>

The Multilateral Convention differs in certain respects from the Article 26 approach to exchange of information:

- (a) The Multilateral Convention more directly and extensively contemplates use of simultaneous audits (Article 8 of the Multilateral Convention; paragraphs 72-82 of the Revised Explanatory Report to the Multilateral Convention);

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<sup>58</sup>Note that the Multilateral Convention more clearly requires States to spontaneously share information (see Article 7 of the Multilateral Convention) than to automatically share information (see Article 6 of the Multilateral Convention).

- (b) The Revised Explanatory Report to the Multilateral Convention has less detail than the Commentary on Article 26 of the United Nations Model Convention on issues other than the use of the three basic modes of exchange (on-request, automatic, and simultaneous).

## **5.4 Regional agreements**

A number of regional agreements can also serve as the legal basis for exchange of information among the signatories. Such regional agreements include: (a) the 2008 WAEMU (West African Economic and Monetary Union) Income and Inheritance Tax Convention (Article 33); (b) the SAARC (South Asian Association Matters for Regional Cooperation) Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance (Article 5); and (c) The Agreement Among the Member States of the Caribbean Community (CARICOM) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion (Article 24).

## **5.5 Other paths for acquiring information**

States can have access to tax information through a variety of mechanisms that operate at the level of the taxpayer or a third party reporting agent. That is to say, although a legal agreement is required if one State seeks to request tax information from another country, a State can use domestic laws to require taxpayers or third parties (not States) to provide certain information. These mechanisms have received increased attention in recent years (some are new, or their active use is relatively new). Even if a State does not have such rules currently in place itself, it is useful to be aware of the reliance on these domestic provisions by other States, and their potential impact on taxation. Such provisions include:

- (a) Foreign Account Tax Compliance Act (FATCA) and Report of Foreign Bank and Financial Accounts (FBAR)

Both of these regimes are United States of America domestic regulatory regimes. They are worth noting for two reasons. First, they are examples of domestic efforts to force

taxpayers and third parties to provide additional information to the Government. FBAR is a reporting requirement imposed on parties who have some type of control over, or relationship to, a foreign bank account (not necessarily beneficial ownership). The core idea is that if the account is disclosed it is much easier for the tax administration to track down any corresponding income. FATCA, which has been enacted but is not yet in full effect in 2013, is a regulatory regime imposed on certain “foreign financial institutions” (FFIs) which requires them to provide information regarding United States taxpayers who have accounts at the FFI. Failure to provide this information to the United States can result in additional United States tax being imposed on certain income earned by the FFI itself in the United States. In the case of FATCA, the unilateral decision by the United States to implement a domestic regime has led, over the past year or so, to a multilateral response. A number of countries are signing Intergovernmental Agreements (IGAs) with the United States to establish a more realistic way for their resident FFIs to comply with FATCA. Perhaps of greater interest was the announcement in April 2013, that several European Union Member States were working together to develop their own agreement on financial account information sharing, prompted by the FATCA legislation in the United States and by the bilateral IGAs that many countries are signing with the United States. All States should be attentive to increased efforts to use third parties (particularly financial intermediaries) to provide information, particularly automatically generated and provided information.

(b) Voluntary disclosure program

States can, and do, implement programmes that encourage their own taxpayers to come forward and volunteer to disclose to the government their own failure to report income and failure to file required forms — and correspondingly pay the tax due. Voluntary disclosure programmes often have a theme, for example, failure to report income from foreign financial accounts. For these programmes to be successful there needs to be (a) some credible threat that the government is actively

auditing that issue, and (b) a clear advantage to participants in the voluntary disclosure programme (for example, reduced penalties). What do governments get from voluntary disclosure programmes? Not only do they get information regarding the participating taxpayer, but also they can get (and may require) information regarding financial institutions, advisors and others who assisted the disclosing taxpayer in avoiding their tax obligations. This third-party information can be used to identify additional taxpayers engaged in tax evasion and fraud.

## Chapter X

# Improper use of tax treaties, tax avoidance and tax evasion

PHILIP BAKER\*

### 1. Introduction

This chapter focuses on several issues, all of them linked to the theme of tax avoidance. In summary, it deals with the following:

- How to prevent tax treaties from being used improperly as a basis for tax avoidance
- How to ensure that tax treaties do not prevent the effective operation of domestic anti-avoidance rules
- How to use the administrative assistance provisions in tax treaties as an effective mechanism to support the operation of domestic anti-avoidance rules.

These main issues are considered in more detail below.

### 1.1 Preventing the improper use of tax treaties

Tax treaties offer a range of tax advantages which countries agree to grant to each other in order to prevent double taxation and eliminate the barrier that double taxation would create to cross-border trade, investment, movement of persons, etc. Examples of these tax advantages are: exemption from tax in one or other of the countries;<sup>1</sup> reduced withholding taxes on dividends, interest and royalties;<sup>2</sup> and

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<sup>1</sup>For example, under Article 13 (6) of the United Nations Model Double Taxation Convention between Developed and Developing Countries (New York: United Nations, 2011) (United Nations Model Convention).

<sup>2</sup>Under Articles 10, 11 and 12 of the United Nations Model Convention.

a foreign tax credit or exemption to eliminate double taxation.<sup>3</sup> These tax advantages are liable to attract the attention of tax planners. For the countries concerned, it is a matter of ensuring that the tax treaty is not improperly used and that the tax advantage does not operate to the benefit of persons for whom it is not intended. At the same time, however, it is important that the tax advantage is granted to those who are genuinely entitled to it; to refuse the tax advantage in cases where there is no improper use of the tax treaty would defeat the objective of the two countries in entering into it.

## **1.2 The relationship between domestic anti-avoidance rules and tax treaty provisions**

All tax systems will contain some specific, and often some general, anti-avoidance rules. In a cross-border context these rules might sometimes operate to tax a transaction where a provision in a tax treaty would have the effect of preventing the tax being imposed. For example, where a taxpayer has artificially transferred a source of income to a resident of another country, anti-avoidance legislation<sup>4</sup> might allow the country from which the transfer has been made to continue to tax the income arising. However, a tax treaty may say that the income is taxable only in the other country, and this could be raised as a defence to the anti-avoidance legislation. If this has been deliberately planned, the use of the tax treaty to defeat the operation of a domestic anti-avoidance rule is an example of a form of tax treaty abuse.

## **1.3 Supplementing domestic anti-avoidance rules**

Many domestic anti-avoidance rules can only operate effectively if the revenue authorities know about the tax avoidance scheme or can collect accurate information about the income which is caught by the anti-avoidance rule. In a cross-border context, traditionally it would have been very difficult to obtain this information from another country. The provisions for administrative assistance by exchange of

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<sup>3</sup>Under Article 23 A or B of the United Nations Model Convention.

<sup>4</sup>For example, controlled foreign company legislation or transfer of assets abroad legislation.

information,<sup>5</sup> and sometimes by assistance in the collection of taxes,<sup>6</sup> may supplement the operation of domestic anti-avoidance rules so that they become more effective.

#### **1.4 The Commentary to the United Nations Model Convention and tax avoidance**

There is an extensive discussion of the improper use of tax treaties and of tax avoidance in paragraphs 8-103 of the Commentary on Article 1 of the United Nations Model Convention. That Commentary elaborates on many of the points discussed in this chapter; cross-references to the relevant paragraphs of that Commentary are included here, and may be consulted accordingly.

It should also be noted that several of the articles of the United Nations Model Convention contain specific anti-avoidance rules, and these are described elsewhere in this Handbook when the particular articles are considered.<sup>7</sup> Again, cross-references relating to those specific anti-avoidance provisions are included, either elsewhere in this Handbook or in the relevant Commentary to the United Nations Model Convention.

#### **1.5 A note on terminology — Avoidance, evasion and fraud; abuse of tax treaties**

Many national tax systems make a distinction between tax evasion, which involves a taxpayer escaping from a tax liability that has already arisen (and which is a criminal matter), and the avoidance of tax liabilities that have not otherwise arisen (which is not criminal though it may possibly give rise to a tax penalty). Tax evasion involves, for example, the deliberate concealment of income or the deliberate

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<sup>5</sup>See Article 26 of the United Nations Model Convention.

<sup>6</sup>See Article 27 of the United Nations Model Convention.

<sup>7</sup>For example, see chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede, and, more generally, see chapter I, section 8, Overview of major issues in the application of tax treaties, by Brian J. Arnold. On the administration of anti-avoidance rules, see chapter III, section 3, Taxation of residents on foreign source income, by Peter A. Harris.

mis-reporting of income, and can best be regarded as a form of fraud. Not all tax systems make this distinction so clearly, but it is helpful to think in terms of tax fraud (which involves criminal conduct), and tax avoidance (which may be unacceptable but does not involve criminal conduct).

Many tax treaties have a long title which refers to “the avoidance of double taxation and the prevention of fiscal evasion”.<sup>8</sup> On first impressions, one might think that the tax treaty was only concerned with combating tax evasion and only with criminal conduct by taxpayers. This formulation of the long title has a history to it, and goes to the period before the Second World War when the distinction between tax avoidance and tax evasion was not so carefully made. In practice, the exchange of information provisions in tax treaties, for example, are more commonly used to counter tax avoidance rather than tax evasion. Where criminal tax fraud is involved, different international instruments for co-operation in the investigation and prosecution of criminal offences are more usually used as a basis for administrative assistance.<sup>9</sup>

One terminological issue that presents itself is the question of what constitutes an abuse of a tax treaty. This is discussed in paragraphs 23–26 of the Commentary on Article 1 of the United Nations Model Convention. Quoting the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital<sup>10</sup> (OECD Model Convention), the United Nations Commentary adopts the following “guiding principle”:

“A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in

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<sup>8</sup>See, for example, Title to the United Nations Model Convention, footnote 7.

<sup>9</sup>For example, mutual legal assistance conventions relating to co-operation in criminal matters.

<sup>10</sup>Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010).

these circumstances would be contrary to the object and purpose of the relevant provisions.”

The United Nations Committee of Experts on International Cooperation in Tax Matters endorsed that principle, and the Commentary explains<sup>11</sup> that two elements must be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of the tax treaty: (a) a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position; and (b) obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions. In deciding what is the object and purpose of the relevant provisions of the tax treaty, the relevant Commentary to the United Nations Model Convention will clearly be of assistance.

## **2. Improper use of tax treaties**

This section deals with ways of ensuring that the tax advantages in a tax treaty are enjoyed only by those persons who the two countries intended could do so, and that the treaty is not used improperly to obtain an unintended benefit. It first considers how countries can ensure that treaties are not used improperly, and then several examples of transactions involving potential abuse of tax treaties are considered.

### **2.1 The ways in which a country may ensure that a tax treaty is not used improperly**

The Commentary on Article 1 of the United Nations Model Convention sets out six different approaches used by countries to prevent and address the improper use of tax treaties.<sup>12</sup> Each of these approaches is summarized below.

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<sup>11</sup>Paragraph 25 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>12</sup>Paragraphs 10-39 of the Commentary on Article 1 of the United Nations Model Convention.

### **2.1.1 Specific legislative anti-abuse rules found in domestic law<sup>13</sup>**

It is possible for countries to adopt in their domestic law specific anti-abuse rules that prevent particular types of improper use of tax treaties. For example, if a country faces a problem of taxpayers moving their residence temporarily to another country in order to take advantage of the tax treaty with that country to prevent a charge to tax (for example a taxpayer moving temporarily to take advantage of the capital gains article to secure exemption on the disposal of assets), the country might enact a specific anti-avoidance rule to prevent that treaty abuse. This rule might provide, for example, that the country can continue to tax the particular income or capital gain, notwithstanding the provisions of the tax treaty where the taxpayer moves temporarily abroad with the intention of avoiding a tax charge.

Because these specific anti-avoidance rules prevent the enjoyment of the tax advantage that would otherwise be given by the tax treaty, they can be seen as a form of tax treaty override. However, the two countries concerned may agree that the advantage should not be enjoyed, and explicitly state in the tax treaty that treaty benefits will not be enjoyed where the specific anti-abuse rule applies. These rules also raise the issue of the interrelationship between domestic anti-avoidance rules and tax treaty provisions, which is the issue dealt with in section 3 of this chapter.

### **2.1.2 General legislative anti-abuse rules found in domestic law<sup>14</sup>**

Some tax systems contain a general anti-abuse rule (GAAR) in the domestic tax legislation. Again, there is a possible danger of conflict between this general anti-abuse rule and the provisions of a tax treaty. This is addressed further in section 3 of this chapter, but the Commentary to the United Nations Model Convention<sup>15</sup> (and the

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<sup>13</sup>Paragraphs 12-19 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>14</sup>See paragraphs 20-27 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>15</sup>Paragraphs 21 and 22 of the Commentary on Article 1 of the United Nations Model Convention.

Commentary to the OECD Model Convention) confirm that such rules are part of the basic domestic rules for determining which facts give rise to a tax liability, and that these rules are not affected by tax treaties.

The point might be made that general anti-abuse rules are often enacted by countries to deal with innovative and often highly-artificial tax avoidance structures. Some of those structures attempt to take advantage of the provisions in domestic tax law, but others take advantage of tax benefits granted by tax treaties. It would risk the danger of making such general anti-abuse rules significantly less effective if they did not apply to abusive arrangements exploiting the provisions in tax treaties. In principle, therefore, general anti-abuse rules found in domestic law should operate in such a way that they deny the benefits of tax treaties where the rules are applicable.

### **2.1.3 Judicial doctrines that are part of domestic law**

Some countries have developed through their courts various anti-avoidance doctrines, such as the “substance over form” doctrine or the concept of “abuse of law”. These are essentially doctrines relating to interpretation of tax legislation. According to the Commentary on Article 1 of the United Nations Model Convention, nothing prevents the application of similar judicial approaches to the interpretation of provisions of tax treaties.<sup>16</sup>

### **2.1.4 Specific anti-abuse rules found in tax treaties<sup>17</sup>**

A number of specific anti-abuse rules are found in the United Nations Model Convention (and some of them are dealt with elsewhere in this Handbook).<sup>18</sup> For example, the provision relating to “star companies” in Article 17 (2) of the United Nations Model Convention is intended to counter a particular form of avoidance which might be used by

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<sup>16</sup>Paragraphs 28-30 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>17</sup>Paragraphs 31-33 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>18</sup>For example, see chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

artistes or sportspersons who assign their income to other persons, typically a company under their control. Reference should be made to the Commentary to the specific article where the anti-abuse provision is located.

### **2.1.5 General anti-abuse rules found in tax treaties<sup>19</sup>**

Aside from specific anti-abuse rules, some countries have the practice of including a general anti-abuse rule in their bilateral tax treaties. The current version of the United Nations Model Convention does not contain such a general anti-abuse rule but there are examples of the type of wording that some countries have included in paragraphs 34-36 of the Commentary on Article 1 of the United Nations Model Convention.<sup>20</sup>

Paragraph 37 of the Commentary on Article 1 of the United Nations Model Convention also contains a warning that the inclusion of such general anti-abuse rules might give the impression that, absent such a provision, other general approaches to deal with improper use of tax treaties are not possible. This is clearly a warning that countries should consider carefully before including such general anti-abuse rules in their treaties.

### **2.1.6 The interpretation of tax treaty provisions<sup>21</sup>**

Provisions contained in a tax treaty are subject to interpretation, and Article 31 of the Vienna Convention on the Law of Treaties<sup>22</sup> provides that treaties are to be interpreted in good faith in the light of their object and purpose. There is some support for an approach that a good faith interpretation, consistent with a tax treaty's object and purpose, would lead to a conclusion inconsistent with the abuse of tax treaty

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<sup>19</sup>Paragraphs 34-37 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>20</sup>On limitation on benefit (LOB) articles, see chapter II, section 3.4, Persons qualifying for treaty benefits, by Joanna Wheeler.

<sup>21</sup>Paragraphs 38 and 39 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>22</sup>Convention on the Law of Treaties, Vienna, 23 May 1969.

provisions.<sup>23</sup> At present, however, the support is not overwhelming, and this is an issue that should be considered very carefully before a revenue authority raises it.

## **2.2 Some common examples of transactions involving potential abuse of tax treaties**

This part of the section considers six common examples of transactions involving potential abuse of tax treaties, and discusses the ways in which they may be countered using the various techniques described in the previous part. These examples are not a complete list of all possibilities: some additional ones are discussed in paragraphs 40-99 of the Commentary on Article 1 of the United Nations Model Convention. Even the examples in the Commentary are not exhaustive, and countries will no doubt encounter novel forms of improper use of tax treaties which also need to be countered by using one of the techniques described above.

### **2.2.1 Treaty shopping and the use of conduit companies<sup>24</sup>**

Perhaps the most common example of tax treaty abuse is treaty shopping, where a person who is not entitled to the benefits of a tax treaty establishes arrangements which employ other persons who are entitled to them to indirectly access the benefits of the treaty. To take a simple example, suppose that a person who is resident in Country A derives income from a source in Country C, but there is no tax treaty between Countries A and C. However, there is a tax treaty between Country B and Country C which offers an attractive tax advantage. The person establishes an entity — typically a “conduit company” — in Country B so that the income flows to that company, which enjoys the benefit of the tax treaty with Country C. Such arrangements will often also rely upon the ability to extract income from Country B without paying any tax in that country or on the payment out from that country.

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<sup>23</sup>At present the international case law on this issue is relatively thin, the leading case being a Swiss Federal Supreme Court decision in *A Holdings ApS v Federal Tax Administration* (2006) 8 ITLR 536.

<sup>24</sup>Paragraphs 47-57 of the Commentary on Article 1 of the United Nations Model Convention. See also chapter II, section 5, Persons qualifying for treaty benefits, by Joanna Wheeler.

Treaty shopping is not a new phenomenon, and the use of conduit companies was discussed by the OECD in a report adopted in 1986.<sup>25</sup>

Various methods are suggested in the Commentary on Article 1 of the United Nations Model Convention to deal with treaty shopping, and the Commentary to the OECD Model Convention also contains further discussion of this issue.<sup>26</sup> One example of a specific anti-abuse rule found in most tax treaties is the “beneficial ownership” concept in Articles 10, 11 and 12 of the United Nations Model Convention.<sup>27</sup> An examination of the identity of the beneficial owner of dividends or interest, for example, may be an approach that effectively counters an attempt to abuse a treaty by treaty shopping.

### 2.2.2 Income shifting<sup>28</sup>

This topic covers a range of transactions and arrangements that are designed to achieve the result that income that would normally accrue to a taxpayer accrues instead to a related person or entity with the aim of ensuring that treaty advantages are obtained that would not otherwise be available. A simple example might be the use of a “base company”, often situated in a low-tax jurisdiction, to which property is transferred so that income accrues to that company. There are other examples of income shifting in the Commentary on Article 1 of the United Nations Model Convention.

Income shifting can be challenged using the various methods described above. For example, base companies may be challenged by

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<sup>25</sup>OECD, *Double Taxation Conventions and the Use of Conduit Companies*, 27 November 1986.

<sup>26</sup>This is quoted in paragraph 56 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>27</sup>On the notion of beneficial owner, see chapter II, section 4.2 and bibliography, *Persons qualifying for treaty benefits*, by Joanna Wheeler.

<sup>28</sup>Various examples of income shifting are discussed in paragraphs 62-80 of the Commentary on Article 1 of the United Nations Model Convention. See also chapter II, section 5.3, *Persons qualifying for treaty benefits*, by Joanna Wheeler.

the use of Controlled Foreign Corporation (CFC) legislation, which is an example of a specific anti-avoidance rule in domestic law.<sup>29</sup>

### **2.2.3 The international hiring-out of labour<sup>30</sup>**

Under Article 15 of the United Nations Model Convention, an employee who is a resident of Country A and who goes to work in Country B for less than 183 days will only be taxable in Country B on his salary if his employer is a resident of country B (or has a permanent establishment in Country B). This has led in the past to a tax avoidance scheme under which employees were sent to work in a country, but their legal contract of employment was with an employer resident outside that country. This would be the case even though the employee was working for the economic benefit of a company in the host State. This gave rise to a problem generally referred to as “international hiring-out of labour”.

The answer to this problem is discussed in the Commentary on Article 15 of the United Nations Model Convention and involves a correct interpretation of the tax treaty to identify who in reality is the employer of the worker. Some of the approaches discussed above may be applied to identify as the true employer the company that directs the work of the employee and receives the economic benefits from that work (sometimes referred to as “the economic employer”).

### **2.2.4 Circumventing treaty threshold requirements<sup>31</sup>**

Several provisions found in tax treaties contain thresholds which alter the taxing rights of the two countries. For example, under Article 10 (2) of the United Nations Model Convention the level of withholding tax on dividends paid by a company is generally lower where the shareholder company has a direct investment of at least 10 per cent

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<sup>29</sup>It is then important to ensure that the operation of the CFC legislation is not impeded by the tax treaty, which issue is addressed in section 3.

<sup>30</sup>Paragraph 81 of the Commentary to Article 1 of the United Nations Model Convention. It was also the topic of an OECD Report in 1985, which is included in “Trends in International Taxation” (OECD, Paris 1985).

<sup>31</sup>Paragraphs 94-99 of the Commentary on Article 1 of the United Nations Model Convention.

in the company paying the dividend.<sup>32</sup> A company might enter into an artificial arrangement under which it is able to meet the requirement of the threshold and obtain the lower level of withholding tax, even though the substance (as opposed to the form) is a portfolio investment below the threshold. The Commentary on Article 10 of the United Nations Model Convention outlines ways of responding to this type of avoidance.

### **2.2.5 Changing the character of income<sup>33</sup>**

The substantive articles of any tax treaty allocate taxing rights between the countries according to the classification of the income (business income, dividends, interest, royalties, etc.) If the classification of income can be changed, then the result may be that the taxing rights of one of the countries are reduced and the result is not that intended by the two countries. A common example is the situation where a tax treaty has a higher level of withholding tax at source on dividends as compared to the withholding tax on payments of interest. Taxpayers may structure their arrangements to ensure that income which is really the distribution of profits (and so should be treated as a dividend) takes the form of a payment of interest, with a lower withholding tax as a result.

This type of tax avoidance may be countered by the correct interpretation of the definitions of the different categories of income. Alternatively, it may be necessary to include a specific anti-avoidance provision in a tax treaty if tax avoidance through modifying the classification of income is a common phenomenon.

### **2.2.6 Tax sparing abuses**

Some tax treaties with developing countries provide for a tax sparing credit. This is a credit given in the country of residence of the investor, not just for tax actually paid to the developing country, but a

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<sup>32</sup>Other examples include the time limits for a permanent establishment in Article 5 (3), and the level of immovable property owned by a company, a partnership, trust or estate for the purposes of Article 13 (4) of the United Nations Model Convention.

<sup>33</sup>Paragraphs 86-93 of the Commentary on Article 1 of the United Nations Model Convention.

“shadow-credit” for tax that would have been charged in the host country except for tax-incentive legislation which offered a reduced rate or an exemption from tax for activities which are seen as encouraging economic development.<sup>34</sup>

These types of tax sparing credits could give rise to a form of abusive avoidance if, for example, a taxpayer claims a shadow credit to which the taxpayer is not entitled. If a tax treaty provides for a tax sparing credit, it may be necessary for the country of residence of the investor to check carefully (using the provisions for exchange of information described below) to ensure that the shadow credit is only granted in circumstances where the taxpayer is properly entitled. This is one of several potential abuses of tax treaties where the exchange of information may be particularly valuable in assisting countries to combat tax treaty abuse.

### **3. The relationship between domestic anti-abuse rules and tax treaties**

The second aspect of the improper use of tax treaties addressed in this chapter concerns the relationship between domestic anti-avoidance (or anti-abuse) rules and tax treaties. It is important that the operation of domestic anti-avoidance rules (whether specific or general rules) is not rendered ineffective by the provisions of a tax treaty. An example where this has proved problematic in the past has concerned Controlled Foreign Corporation (CFC) legislation under which the profits received by a controlled subsidiary in a low-tax jurisdiction are attributed to the controlling parent company and taxed, either as a deemed distribution of that company or as profits of that company. Where the subsidiary is resident in a country which has a tax treaty with the country of residence of the parent company, it has sometimes been argued that provisions (such as the business profits Article) of the tax treaty prevent the operation of the CFC legislation.<sup>35</sup> Where

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<sup>34</sup>See also chapter I, section 6.2.3, Overview of major issues in the application of tax treaties, by Brian Arnold.

<sup>35</sup>This has arisen in several countries: for examples of court cases on this question, see the decision of the French court in *Re Schneider SA* (2002) 4 ITLR 1077, and of the English court in *Bricom* (1997) 1 OFLR 365.

the arrangements have been entered into with a view to relying upon the provisions of the tax treaty to prevent the operation of the anti-avoidance legislation, this may be regarded as an improper use of tax treaties.

The issue of possible conflicts between anti-abuse rules and the provisions of tax treaties is dealt with in paragraphs 14-19 of the Commentary on Article 1 of the United Nations Model Convention. The conclusion is that such conflicts may often be avoided by applying a detailed analysis of the operation of the provisions. Where the possibility of a conflict is foreseen at the time of the negotiation of a tax treaty, the solution that gives the greatest certainty is to include an express provision in it confirming that its provisions do not prevent the application of the domestic anti-avoidance rule (or, perhaps, the contrary). The problematic cases have occurred where the treaty was silent on the point, so that the argument could be made that the treaty prevented the operation of the anti-avoidance legislation.

This issue is also discussed in the OECD Model Convention, and reference may be made to paragraphs 7-26.2 of the Commentary on Article 1 of the OECD Model Convention.

#### **4. Detecting and combating aggressive tax avoidance schemes involving tax treaties**

All countries are likely to have provisions in their domestic law for combating aggressive tax avoidance schemes. These may be specific anti-avoidance rules that counter particular types of schemes, or they may be general anti-avoidance rules. There will also be laws criminalizing tax fraud, such as the deliberate concealment of assets offshore.

However, in a cross-border context the effectiveness of these anti-avoidance rules may be significantly reduced because a country cannot obtain accurate information (or sometimes any information) about a taxpayer's assets or activities offshore.

The effectiveness of domestic anti-avoidance rules may also be undermined because a taxpayer's assets are located offshore, and it is impossible to enforce a tax debt in the other country.

As regards both these issues, tax treaties can significantly improve the effectiveness of anti-avoidance rules through the provisions for mutual administrative assistance contained in the treaties.

The primary provision for mutual administrative assistance is the exchange of information provision based upon the equivalent of Article 26 of the United Nations Model Convention. Since 2011, however, the United Nations Model Convention has also contained a second provision for mutual administrative assistance in the collection of taxes in Article 27 (and the OECD Model Convention has included a similar provision since 2003). Each of these is considered below.

#### **4.1 Exchange of information<sup>36</sup>**

Provisions in tax treaties based on the United Nations Model Convention are not the only ways in which countries can agree to exchange information. On a bilateral basis, countries may enter into Tax Information Exchange Agreements (TIEAs) which differ from comprehensive tax treaties in that they deal only with administrative assistance through the exchange of information. Since 2011, the OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters<sup>37</sup> has been opened for signature by countries that are not members of the OECD or the Council of Europe. The Multilateral Convention has extensive provisions for mutual administrative assistance through the exchange of information and through cross-border assistance in the collection of taxes.

It is normal practice to include an article on exchange of information in all bilateral tax treaties, generally based upon Article 26 of the United Nations or OECD Model Conventions. The scope of this Article has changed in the different editions of the two Model Conventions, and is now significantly more extensive than previously. Thus, under the current version of Article 26 of the United Nations Model Convention, exchange of information is not restricted by

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<sup>36</sup>See chapter IX, Exchange of information, by Diane M. Ring.

<sup>37</sup>OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters, available at [http://www.oecd.org/ctp/exchange-of-tax-information/Amended\\_Convention\\_June2011\\_EN.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/Amended_Convention_June2011_EN.pdf)

Articles 1 and 2 of the Model Convention, so that it is not limited only to persons who are residents of one or both of the treaty States, nor is it limited only to the taxes covered by the tax treaty. The test for exchange of information is whether that information is “foreseeably relevant” either for carrying out the provisions of the tax treaty, or for the administration or enforcement of domestic tax laws. It is the exchange of information for the purposes of implementing domestic anti-avoidance rules that is particularly highlighted here.

Traditionally, provisions for exchange of information such as Article 26 of the United Nations Model Convention cover three forms of exchange of information. First, exchange on request where a specific request is made by one State for information from the other. Secondly, spontaneous exchange of information where the tax authorities of one State receive information which they consider would be foreseeably relevant for the administration of taxes in the other State. Thirdly, automatic exchange of information where certain categories of information—payments of bank interest to account holders resident in the other State, for example—are exchanged on an automatic and regular basis. Automatic exchange of information, in particular, may identify taxpayers who have sought to avoid tax by transferring assets abroad and have failed to include the income from those assets in their tax returns.

The effectiveness of automatic exchange of information depends to a very large extent on the ability of the State receiving the information to tie it to a particular taxpayer in their jurisdiction. Accurate information as to the beneficial owner of the income, or even the owner’s taxpayer identification number, can greatly assist in improving effectiveness.

The current version of Article 26 of the United Nations Model Convention reflects the development of the most recent international consensus on exchange of information. Thus, under Article 26 (4) of the United Nations Model Convention, the requested State is required to use its information gathering measures to obtain the information requested, even though it does not need the information for its own tax purposes. Put another way round, the requested State cannot decline to gather and supply information solely because it has no domestic interest in such information. Previously, it was the position

of some countries that they would supply information already contained in their files, but would not go out and gather information solely for the purposes of exchange. The “no domestic interest” consensus now requires the gathering of information solely for the purposes of exchange with another country.

Secondly, Article 26 (5) of the United Nations Model Convention reflects the consensus that a State may not decline to supply information because it is held by a bank or another person in a fiduciary capacity, for example. This reflects the consensus that banking secrecy should not be a barrier to exchange of information between countries for tax purposes.

Finally, Article 26 (6) of the United Nations Model Convention authorizes the competent authorities to develop appropriate methods and techniques concerning exchanges of information. This would provide a basis for agreements to identify categories of information to be subject to automatic exchange, as well as other methods for using the exchange of information to supplement the effectiveness of anti-avoidance provisions. Examples might be agreements between the competent authorities to carry out joint audits of taxpayers who operate in both of the countries concerned, or a sharing of information between the two competent authorities relating to aggressive tax planning schemes which have been identified in one or other of the countries.

In many respects, the provisions for exchange of information in tax treaties provide one of the most powerful weapons in the hands of revenue authorities to combat both aggressive tax planning schemes and tax fraud.

## **4.2 Assistance in the collection of taxes<sup>38</sup>**

It is sometimes the case that a country is able to identify and combat particular tax avoidance arrangements, but then is unable to collect the tax because the taxpayer’s assets are situated abroad. The 2011 version of the United Nations Model Convention contains in Article 27 a provision for assistance in the collection of taxes. There are also

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<sup>38</sup>See also chapter III, section 4.4, Taxation of residents on foreign source income, by Peter A. Harris.

extensive arrangements for assistance in the collection of taxes in the OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters. These provisions extend to the collection of taxes as well as interest, administrative penalties and costs of collection.

#### **4.3 Internal organization within the tax authority to detect and combat aggressive tax avoidance schemes**

It goes almost without saying that appropriate organizational structures need to be established within each revenue authority to detect and combat effectively any aggressive tax avoidance schemes. This may involve a special unit staffed by trained officials with sufficient experience to identify these schemes and initiate steps to combat them using domestic laws and provisions of tax treaties for exchange of information, for example. The unit needs to have easy access to the personnel responsible for exchange of information (who may function as part of this unit).

This unit also has to be sufficiently trained to distinguish between tax-motivated avoidance, and the sometimes complex activities and structures used by multinational groups which are not tax-motivated and do not constitute aggressive avoidance: valuable resources may be wasted, and damage caused to a country's reputation as a host for foreign direct investment if unnecessary challenges are made to arrangements that are not examples of aggressive tax avoidance.

### **5. Concluding comments**

The view is occasionally expressed that countries should be cautious in entering into tax treaties because they may create opportunities for tax avoidance. The danger of the improper use or abuse of tax treaties certainly exists, and countries need to be aware of this, as well as of the ways in which they can prevent or counter this abuse.

At the same time, through provisions for administrative assistance by exchange of information or assistance in cross-border collection of taxes, tax treaties can give countries a powerful weapon to detect and counter tax avoidance or tax fraud.

Perhaps a final word of warning is necessary. Treaties relieve from double taxation by either reducing taxes or exempting from taxes or granting credits against taxes. If tax avoidance is too readily alleged, and treaty benefits denied, then the advantages of treaties in removing barriers to trade and investment may be nullified. As in cases of domestic tax avoidance, care has to be taken to distinguish between abusive arrangements and those that are consistent with the purposes for which the tax treaty was concluded.

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