Classes #6 & 7 (February 12 and 19). Investment and Other Income

Please read and consider:

1. Articles 10-13, 21 of the OECD Model Treaty and the UN Model Treaty.

2. Article 10-13, 21 of the US Model Treaty (2006).

3. McIntyre, *Investment and Miscellaneous Other Income* (attached).

4. The following Notes and Questions.

Notes and Questions

Dividends

1. How does Article 10 of the OECD Model Treaty allocate taxing rights with respect to dividends between the country in which the shareholder is resident and the country in which the corporation paying the dividend is resident?

2. Note that it is necessary for the beneficial owner of the dividend to be resident in the other treaty country to get the benefits of Article 10. For example, if shares of a corporation resident in Country A are beneficially owned by B, a resident of Country B, the benefits of Article 10 of the treaty between Countries A and B are available to B even if the shares are held by B's agent or nominee who is not resident in Country B. If, however, B is not resident in Country B and the shares are registered in the name of a brokerage firm resident in Country B, the reduced rate of withholding in Article 10 of the treaty is not available. Articles 11 and 12 dealing with interest and royalties have similar beneficial ownership requirements.

3. X, a resident of Country X, owns all of the shares of ABC Company, which is resident in Country Y. ABC Company's only asset is shares of ZCo, which is resident in Country Z. ABC Company receives a dividend of 1 million from ZCo. The treaty between Countries Y and Z provides for a maximum rate of withholding tax on dividends of 15 percent. There is no treaty between Countries X and Z. The rate of withholding tax on dividends under the law of Country Z is 25 percent. What is the rate of withholding tax on the dividend?

4. Article 10 of the OECD Model Treaty distinguishes between portfolio dividends and dividends received by one corporation in respect of a substantial holding in another corporation. A substantial holding exists if the recipient corporation owns 25 percent or more of the capital of the other corporation. Several countries have reduced the ownership threshold to 10 percent. The reason for the reduced rate of tax on these dividends is to reduce the multiple taxation of income earned through corporations. For example, assume Company A, resident in Country A, earns profits of 100, pays tax to Country A of 35, and distributes 65 as a dividend to its sole shareholder, Company B, resident in Country B. If Country B taxes Company B on the dividend and also taxes shareholders of Company B on the dividends paid by it, the cumulative taxes on

the original profits of 100 are likely to be quite high. Accordingly, Country A's withholding tax is limited to 5 percent in recognition of its taxation of the profits out of which the dividend is paid.

5. What is the "capital" of a company referred to in Article 10(2)(a) of the OECD Model Treaty?

6. ACo is resident in Country A and owns 20 percent of the share capital of BCo, resident in Country B. In anticipation of the payment of a dividend, ACo acquires an additional 5 percent of BCo's shares. The day after the payment of the dividend the shares are transferred back to the person from whom they were acquired. Is the reduced rate of withholding in Article 10 available?

7. Dividends are defined in Article 10(3), but only for purposes of Article 10, not the entire treaty. In general, "dividends" means income from shares. The term "shares" is not defined; therefore, it has the meaning under the domestic law of the country applying the treaty. After reviewing the definition, consider whether the following amounts are dividends for purposes of Article 10:

- a dividend in kind?
- a stock dividend or bonus shares?
- a loan to a shareholder?
- a benefit conferred on a shareholder by a corporation (e.g., the sale or lease of corporate property to a shareholder for less than market value)?
- distributions on liquidation?
- repayment of a share's capital?

8. XCo, resident in Country X, carries on business in Country Y through a permanent establishment there. The permanent establishment holds shares of companies resident in Country Y and receives dividends on these shares. Pursuant to Article 10(4), the dividends are taxable by Country Y as business profits under Article 7 if the shares form part of the assets of the PE or are effectively connected with the PE. A similar result applies if a taxpayer carrying on independent services through a fixed base in another country receives dividends on shares effectively connected with the fixed base. In effect, the source country's right to tax the dividends is unlimited under Articles 7 and 14. Similar rules apply to interest and royalties. Note that Article 14 is repealed in the OECD and U.S. models.

9. Article 10(5) prohibits a country from taxing dividends paid by a company resident in the other country even if the dividends are paid out of income earned in the first country. For example, assume that XCo, resident in Country X, earns all of its income in Country Y and pays dividends to shareholders resident in Country Z. If Countries X and Y have a treaty with Article 10(5), Country Y cannot tax the dividend paid by XCo, although it can tax the income earned in Country Y as long as the income is earned through a permanent establishment.

10. Article 10 of the OECD Model Treaty is based on an assumption that both treaty countries have classical corporate tax systems under which income is taxed to the corporation when earned and again to the shareholder when distributed. Many countries today, however, have imputation systems under which the double taxation of corporate income is reduced or eliminated. The

mechanisms used to eliminate double taxation of corporate income vary considerably. The allocation of the right to tax income earned by a corporation between the country in which the corporation is resident and the country in which the shareholder is resident is extremely difficult. See paragraphs 40-67 of the Commentary to Article 10.

Interest

11. The basic principle of Article 11 of the OECD Model Treaty dealing with interest is similar to the basic principle of Article 10 dealing with dividends. The source country has a limited (up to 10 percent) prior right to tax interest arising in the country and paid to residents of the other country. The residence country has an unlimited right to tax the interest, but must give relief for the source country tax.

12. BankCo, a commercial bank, is resident in Country X and derives interest in Country Y from commercial loans made to residents of Country Y. BankCo has a permanent establishment in Country Y through which the loans are made. Assuming that Countries X and Y have a tax treaty similar to the OECD Model Treaty, how is the interest treated?

13. Interest is defined broadly in Article 11(3) to include income from debt-claims, government securities, and bonds and debentures. Penalties for late payment are excluded. Note that, unlike the definition of dividends, there is no reference to domestic law in the definition of interest. Are payments pursuant to an interest rate swap arrangement interest within the definition in Article 11(3)?

14. Note that Article 11 does not deal with the method of taxation used by the source country. Most countries impose tax on interest paid to nonresidents by means of a withholding tax. Note also that Article 11 does not deal with the deduction of interest as an expense. The only provisions of the OECD Model Treaty that deal with the deduction of interest are Articles 7(3) and 24(5).

15. Article 11 applies only to interest arising in one contracting state and paid to a resident of the other contracting state. Article 11(5) provides the source rule for interest. Interest arises in a country if the payer is a resident of the country or if the interest is borne by a permanent establishment in the country. What is the reason for the rule with respect to PEs? When is interest "borne by" a PE?

16. Why are there no source rules, similar to Article 11(5), for dividends and royalties?

17. XCo, resident in Country X, has a PE in Country Y. XCo borrows 1 million at 8 percent interest from a bank resident in Country Z. The borrowed funds are used exclusively for purposes of the PE in Country Y. In which country is the interest income of the bank considered to arise?

18. According to Article 11(6), if there is a "special relationship" between the payer and the recipient of interest and the interest paid is excessive, the source country's right to tax the excess interest is unrestricted. A special relationship is considered to exist if one person controls the other directly or indirectly or if they are related by blood or marriage or if they have a "community

of interests" (see paragraphs 33 and 34 of the Commentary to Article 11). The treatment of the excess interest depends on the domestic law of the countries. Note that, depending on the treatment of the excess interest, other provisions of the treaty may become applicable. For example, if excess interest is treated as a dividend, then Article 10 would apply.

Royalties

19. Under Article 12 of the OECD Model Treaty, the residence country has the exclusive right to tax royalties. In contrast, the UN Model Treaty gives the source country a limited right to tax royalties. Eleven OECD member countries have entered reservations on Article 12 to preserve their right to tax royalties sourced in their countries.

20. As with Articles 10 and 11, the benefit of Article 12 is available only if the beneficial owner is a resident of the other contracting state. Note also that Article 12 does not deal with royalties sourced in a third country. As a result, Article 21 (Other Income) would apply to such royalties.

21. Articles 12(3) and (4), dealing with royalties effectively connected with a PE and excessive royalties respectively, are similar to Article 10(4) dealing with dividends and Articles 11(5) and (6) dealing with interest. See notes 8 and 18 above.

22. Review the definition of royalties in Article 12(2) and then consider whether the following amounts are royalties:

- payments for the use of a patent or copyright
- payments for the use of know-how
- payments for the use of equipment
- payments for the right to exhibit films
- payments for technical assistance
- payments for the right to explore for gas, oil, or minerals
- payments for the acquisition of intangible property
- payments for computer software

23. Note that so-called "mixed" contracts may involve consideration for know-how, tangible goods, the use of copyrights, and technical assistance. In principle, the consideration should be apportioned among the particular types of property or services acquired under the contract and each part should be dealt with appropriately. According to paragraph 11 of the Commentary to Article 12, however, if part of a mixed contract is clearly ancillary or subsidiary to the primary aspect, then the entire consideration may be treated as is appropriate for the primary aspect of the contract.

Gains

24. Under Article 13 of the OECD Model Treaty, the source country is entitled to tax the following gains from the disposition of property:

- immovable property situated in the country and

- movable property which is used in a business carried on through a PE or a fixed base in the country.

Gains from the alienation of ships or aircraft used in international traffic and boats used in inland waterways and movable property connected with the operation of these ships, boats, and aircraft are taxable only by the country in which the effective management is located. All other gains are taxable only by the country of residence.

25. The principle underlying Article 13 is that the country that is entitled under the treaty to tax the income from particular property is also entitled to tax the gains from the disposition of the property. For example, income from immovable property is taxable by the country in which the property is located, and so are any gains from the disposition of such property. For this reason, it is unnecessary for the treaty to define a capital gain. The distinction between a capital gain and ordinary income is a matter for domestic law. Similarly, the computation of the capital gain subject to tax is left to domestic law.

26. X, a resident of Country X, sells shares of a company resident in Country Y. Under the laws of Country X, the gain is not taxable. Is Country Y entitled to tax the gain, assuming that there is a treaty between Countries X and Y similar to the OECD Model Treaty?

27. The term "alienation" is intended to be very broad and covers sales and exchanges of property, gifts, expropriation, and passage of property on death.

28. YCo, resident in Country Y, owns immovable property located in Country X. If YCo sells the property, the gain would be taxable in Country X under Article 13 of the OECD Model Treaty. What if the shareholders of YCo sell their shares of YCo instead?

29. Article 13(1) does not permit a country to tax a gain on the sale of shares of a company whose assets consist exclusively of immovable property situated in the country. See paragraph 23 of the Commentary to Article 13. Several treaties permit the source country to tax such shares. For example, Article 13 of the Australia-Netherlands tax treaty provides as follows:

In *Lamesa Holdings B.V. v. Federal Commissioner of Taxation,* (1997) 36 ATR 589, the Federal Court of Australia held that a Netherlands company was protected from Australian tax on certain share gains by Article 13 of the treaty quoted above. The Netherlands company sold its shares in an Australian company which, through a chain of three other Australian companies, had an interest in gold mining leases. If the leases had been owned directly by the Australian company whose shares were sold, Article 13 would clearly have authorized Australia to tax the gain. The Court held that a literal interpretation of Article 13 to limit it to one tier was appropriate. The fact that the gain on the shares was not taxable in the Netherlands was considered not to be relevant.

30. X is resident in Country X and owns shares in YCo, resident in Country Y. YCo redeems X's shares for an amount in excess of their cost and paid-up capital. Under the laws of Country Y, the amount of the gain is deemed to be a dividend, whereas under the laws of Country X, the gain is a capital gain. What is the result if Countries X and Y have a treaty similar to the OECD Model Treaty?

31. XCo, a resident of Country X, has a PE in Country Y through which it carries on business. XCo also owns portfolio securities issued by residents of Country Y. If XCo sells the securities at a gain, is the gain taxable by Country Y?

32. Most countries provide "rollovers" for certain types of transactions which usually involve only a change in the form of a taxpayer's investment. Under these rollovers, the taxation of any accrued gain or loss is deferred until the property is disposed of. For example, consider the following situation. SubCo is resident in the United States and is a wholly-owned subsidiary of USCo, which is also resident in the United States. SubCo owns real property in Canada with a substantial accrued gain. SubCo is liquidated into its parent and the real property is transferred to USCo. The liquidation is a taxable transaction under Canadian tax law; however, it receives tax-deferred rollover treatment in the United States. If the Canadian property is sold subsequently by USCo, the gain will be subject to U.S. tax, but the Canadian tax previously paid may not be available as a credit.

Article 13(8) of the Canada-United States treaty was added to deal with the potential double taxation in these situations. It provides:

> Where a resident of a Contracting State alienates property in the course of a corporate or other organization, reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that State, if requested to do so by the person who acquires the property, the competent authority of the other Contracting State may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect to such property for the purpose of taxation in that other State until such time and in such manner as may be stipulated in the agreement.

33. Here is a table of the withholding rates agreed to in very recent U.S. tax treaties and protocols, some not yet in effect. Why the differences?

Country	**Dividends**	**Interest**	**Royalties**
Belgium	5/15/0	0/15*	5
Canada	5/15	0/(5/15)*	10
Denmark	5/15/0	0/(5/15)*	0
Finland	5/15/0	0/(5/15)*	0
Germany	5/15/0	0/30*	0
Malta	5/15/0**	10/15*	10
New Zealand	5/15/0	10/0***	5
* contingent interest			

** pension fund
*** banks

Other Income

34. The OECD uses a schedular approach to deal with various types of income. In other words, Articles 6-20 each provide rules for a different type of income. Income not dealt with in these provisions is covered by Article 21. The basic rule of Article 21 is that other income is taxable only by the residence country. However, if the property or right from which the income is derived is effectively connected with a PE or fixed base which the taxpayer has in the other contracting state, then Article 7 applies.

35. The Other Income Article is deceptively simple, but very important. It applies to income sourced in one of the Contracting States or in a third country. According to paragraph 1 of the Commentary to Article 21, the provision applies both to classes of income not expressly dealt with (for example, gambling winnings or lottery prizes) and to income from sources not expressly mentioned (for example, interest and royalties arising in a third country).

36. The following items of income are examples of income covered by Article 21:

- alimony and maintenance
- payments under derivative financial products such as swaps, because the payments are not interest
- payments to and by a partnership
- income from trusts and estates
- social security payments
- prizes and grants
- penalties
- certain foreign currency gains

37. Why is income from immovable property excluded from Article 21(2) in the OECD Model Treaty?

38. Compare Article 21 in the U.S. and OECD models with that article in the UN Model Treaty. What is the difference? Why do you think the difference exists?

39. XCo, a resident of Country X, carries on a money-lending business through a PE in Country Y. The PE makes loans to residents of Country X and receives interest on these loans. What is the appropriate treatment of the interest under the OECD Model Treaty?

Investment and Miscellaneous Other Income

Michael J. McIntyre (2000, revised 2007, 2013)

All tax income treaties entered into by the United States require a Contracting State to reduce or eliminate its source-based taxes on certain investment income earned within its borders by residents of the other Contracting State. Section 1 describes the treaty rules that typically apply to dividends, interest, rents and royalties. Section 2 described the rules applicable to capital gains. The treatment of income not referenced in the treaty ("other income") is discussed in section 3.

Table A, below, sets forth the maximum withholding rates that the United States and its treaty partners are permitted to impose on the main categories of interest, dividends, and royalties. Many tax treaties have special rules for certain subcategories of interest, dividends and royalties. Some countries tax investment income more favorably under their domestic tax legislation than is required under their tax treaties. The table also sets forth the recommended maximum rates contained in the U.S., OECD, and UN model treaties.

Table A
Maximum Tax Rate Under U.S. Tax Treaties on Periodical Income
Not Effectively Connected with a U.S. Permanent Establishment

Treaty/Country	Interest	Dividends			Royalties	
	General	General	Related		Know-How/ Industrial	Films
			10%	80%		
U.S. Statutory Rate	*30*	*30*	*30*	*30*	*30*	*30*
U.S. Model Treaty (2006)	*0*	*15*	*5*	*5*	*0*	*0*
OECD Model Treaty (2012)	*10*	*15*	*5*	*5*	*0*	*0*
UN Model (2011)	*blank*	*blank*	*blank*	*blank*	*blank*	*blank*
Australia (2004)	10	15	15	0	5	5
Austria (1999)	0	15	5	5	0	10
Bangladesh (2007)	10	15	10	10	10	10
Barbados (2005)	5	15	5	5	5	5
Belgium (2008)	15	15	5	0	0	0
Bulgaria (2009)	5	10	5	5	5	5
Canada (2009)	0	15	5	5	0	10
China, PR (1987)	10	10	10	10	10	10
Commonwealth of Independent States (1976)	See Soviet Union.					
Cyprus (1986)	10	15	5	5	0	0
Czech Republic (1993)	0	15	5	5	10	0
Denmark (2008)	0	15	5	0	0	0
Egypt (1982)	15	15	5	5	30	0

Treaty/Country	Interest	Dividends			Royalties	
	General	General	Related		Know-How/ Industrial	Films
			10%	80%		
Estonia (2000)	10	15	5	5	10	10
Finland (2008)	0	15	5	0	0	0
France (2009)	0	15	5	0	0	0
Germany (2008)	0	15	5	0	0	0
Greece (1953)	0	30	30	30	0	30
Hungary (1980)	0	15	5	5	0	0
Iceland (2009)	0	15	5	5	0	30
India (1991)	15	25	15	15	15	15
Indonesia (1990)	10	15	10	10	10	10
Ireland (1998)	0	15	5	5	0	0
Israel (1995)	17.5	25	12.5	12.5	15	10
Italy (2010)	10	15	5	5	8	8
Jamaica (1982)	12.5	15	10	10	10	10
Japan (2005)	10	10	5	0	0	0
Kazakstan (1996)	10	15	5	5	10	10
Korea, Rep. of (1980)	12	15	10	10	15	10
Latvia (2000)	10	15	5	5	10	10
Lithuania (2000)	10	15	5	5	5	10
Luxembourg (2001)	0	15	5	5	0	0
Malta (2011)	10	15	5	5	10	10
Mexico (2004)	15	10	5	0	10	10
Morocco (1981)	15	15	10	10	10	10
Netherlands (2005)	0	15	5	0	0	0
New Zealand (2011)	10	15	5	0	5	5
Norway (1982)	0	15	15	15	0	0
Pakistan (1959)	30	30	15	15	0	30
Philippines (1983)	15	25	20	20	15	15
Poland (1974)	0	15	5	5	10	10
Portugal (1996)	10	15	5	5	10	10
Romania (1974)	10	10	10	10	15	10
Russia (1994)	0	10	5	5	0	0
Slovak Republic (1993)	0	15	5	5	10	0
Slovenia (2002)	5	15	5	5	5	5
South Africa (1998)	0	15	5	5	0	0
Soviet Union* (1976)	30	30	30	30	0	0
Spain (1991)	10	15	10	10	10	8

Treaty/Country	Interest	Dividends			Royalties	
	General	General	Related		Know-How/ Industrial	Films
			10%	80%		
Sri Lanka (2004)	10	15	15	15	10	10
Sweden (2007)	0	15	5	0	0	0
Switzerland (1998)	0	15	5	5	0	30
Thailand (1998)	15	15	10	10	15	5
Trinidad & Tobago (1970)	30	30	30	30	15	30
Tunisia (1990)	15	20	14	14	15	15
Turkey (1998)	15	20	15	15	10	10
Ukraine (2001)	0	15	5	5	10	10
United Kingdom (2004)	0	15	5	0	0	0
Venezuela (2000)	10	15	5	5	10	10
* Terms of the treaty with the former Soviet Union (Commonwealth of Independent States) are in force with respect to Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikstan, Turkmenistan, and Uzbekistan.						

1. Dividends, Interest, Rents, and Royalties

1.1. Interest and Royalties

The U.S. Model Treaty (2006) assigns exclusive tax jurisdiction to the country of residence over royalty income[1] and interest income,[2] with an exception for royalties and interest derived in the source country from conducting business therein through a permanent establishment ("PE"). That is, a country that enters into a tax treaty with the United States based on the U.S. model must exempt from tax any U.S. investors earning royalty and interest income within its borders. Residents of the treaty country investing in the United States receive a reciprocal benefit. As shown in Table A, above, many U.S. tax treaties follow the U.S. model in exempting interest and royalties.

The OECD Model Treaty (2012) permits interest income to be taxed in the source country up to a maximum withholding rate of 10 percent.[3] In accordance with the OECD model, many U.S. tax treaties set the maximum withholding rate on interest income at 10 percent.[4] The UN model leaves the maximum withholding rate on royalties to negotiations between the two treaty countries.

[1] OECD Model Treaty (2012), Art. 12.

[2] OECD Model Treaty (2012), Art. 11.

[3] OECD Model Treaty (2012), Art. 11.

[4] The Code provides that foreign investors are exempt from tax on some categories of interest income. For taxpayers qualifying for an exemption under the Code, the treaty rule is irrelevant.

In accord with the U.S. model, the OECD model assigns exclusive tax jurisdiction to the residence country with respect to royalties.[5] In contrast, the UN Model Treaty (2001) gives the source country a limited right to tax royalties, subject to negotiations between the treaty partners. As shown in Table A, above, many U.S. treaties provide for no taxation in the source country with respect to royalties. Many other treaties, however, provide for some sharing of tax revenues between the source country and the residence county.

1.2. Dividends

The U.S. and OECD model treaties propose substantial limitations on source taxation of dividends. The maximum recommended rate for portfolio dividends in the two models is 15 percent. Five percent is the maximum recommended rate on direct-investment dividends—that is, dividends paid to a company owning 10 percent or more of the voting shares of the distributing company.[6] A substantial majority of U.S. treaties follow the rate pattern recommended in the U.S. and OECD models. In 2003, the United States negotiated a treaty with the United Kingdom that provide for a zero rate of withholding on dividends paid to a company owning 80 percent or more of the voting shares of the distributing countries. There are now 10 treaties that have been negotiated with that provision, all with developed countries. In part, this provision may be intended to match the provision for tax-free dividends within the European Community as a result of the Parent-Subsidiary Directive adopted in 2007. Tax-free dividends are also provided for dividends received by a pension fund.

Setting the maximum rate of tax on direct-investment dividends at 5 percent rather than 15 percent reduces the multiple taxation of income earned through corporations. For example, assume that ACo, resident in Country A, earns profits of $100 and pays tax to Country A on those profits of $40. ACo then distributes the after-tax profits of $60 as a dividend to its sole shareholder, USCo, a resident in the United States. If Country A imposes a 15 percent withholding tax on the dividend to USCo after taxing ACo at 40 percent on its profits, the cumulative corporate taxes paid to Country A on the original profits of $100 will be $49 ($40 + 15% of $60). That cumulative burden on the income earned by USCo through ACo is significantly higher than the burden that either the United States or Country A imposes on corporate profits earned by domestic companies.

A few U.S. tax treaties authorize a withholding rate on portfolio dividends in excess of the 15 percent maximum set in The U.S. Model Treaty (2006).[7] Deviations from the recommended 5-percent maximum rate on direct-investment is fairly common, especially in U.S. treaties with developing countries.[8] Many developing countries are profligate in their use of tax holidays to attract foreign investors. They are apparently unwilling to negotiate away their dividend withholding tax when it is likely to be their only effective tax on corporate profits. The

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[5] OECD Model Treaty (2012), Art. 12. Eleven OECD member countries have entered reservations on Article 12 to preserve their right to tax royalties sourced in their countries.

[6] OECD Model Treaty (2012), Art. 10.

[7] See, e.g., U.S./Israel treaty, Art. 12(2)(a) (25% maximum rate).

[8] See, e.g. U.S./China treaty, Art. 9(2) (allowing a 10% rate); U.S./India treaty, Art. 10(2)(a) (allowing a 15% rate).

withholding tax may also encourage foreign investors to keep their profits invested in the developing country.

1.3. Rents

The U.S. Model Treaty (2006) does not include a special article for rental income. The OECD model and UN model are the same in this regard. All U.S. tax treaties are in accord with the three models in this respect. The treatment of rental income under a tax treaty depends, therefore, on the way the income is characterized under other articles of the treaty.

Under the U.S. model, rental income generally is not taxable in the source country unless it constitutes (1) business income earned through a PE or (2) rental income derived from real property located in the source state. Rental income falling outside those two categories generally would be classified as "other income" within the meaning of Article 21 of the U.S. model. For example, if A rents a car in Country A for use in Country B and the rental company has no PE in Country B, then the rental income would not be taxable in Country B under the Other Income article. As a result, the residence country would have the exclusive right to tax the rental income. Rental income derived from renting boats for use in international traffic would be governed by Article 8(2) of the U.S. model. Under that article, only the residence state could tax the income.[9]

2. Capital Gains

The general rule set forth in Article 13 of The U.S. Model Treaty (2006) is that gains derived from the disposition of property are taxable exclusively in the Contracting State where the holder of the property is resident. The source country is permitted to tax gains from the disposition of real (immoveable) property located in that country. The source state is also permitted to tax gains derived from the disposition of personal (moveable) property used in a business that is carried on in the source country through a PE or a fixed base.[10] The OECD model includes the same rule.[11] The principle underlying these exceptions to the general rule is that the source country should be entitled to tax the gains from the disposition of property if it is permitted under the treaty to tax the income generated by that property.[12]

A few U.S. treaties depart from the U.S. model and generally permit taxation of gains in accordance with the domestic laws of the Contracting States.[13] These treaties make an exception for gains derived from the disposition of property used by a shipping or air transport business that is exempt by treaty from tax in the source country.

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[9] See, e.g., U.S./Austria treaty, Art. 8(2). Treaties following the U.S. model would exempt rental income derived from containers used in international traffic from taxation in the source country. See, e.g. U.S./Canada treaty, Art. VIII(2)(b).

[10] OECD Model Treaty (2012), Art. 13(3). See, e.g., U.S./Italy treaty, Art. 13(2); U.S./Turkey treaty, Art. 13(3). The term "fixed base" is used in Article 14 (Independent Personal Services). That article was eliminated from the OECD Model Treaty in 2000.

[11] OECD Model Treaty (2012), Art. 13(2).

[12] OECD Commentary to Article 13, para. 4.

[13] See U.S./India treaty, Art. 13; U.S./Thailand treaty, Art. 13(1).

Whether income related to a disposition of property is taxable as a capital gain or as ordinary income is strictly a matter for domestic law. U.S. tax treaties based on the U.S. model have no need to distinguish between capital gains and ordinary income because all of the income associated with particular assets either is exempt from source taxation completely or is subject to source taxation completely.

3. Other Income

Article 21 of The U.S. Model Treaty (2006) provides a residual rule for items of income not addressed in other articles of the treaty. In general, the residual rule assigns exclusive jurisdiction to tax unmentioned items to the residence country. The OECD Model Treaty (2005) provides the same general rule. No justification for this residual rule is offered in the OECD Commentary to its model treaty. The Treasury's technical explanation to the U.S. model also offers no justification for the rule.

One effect of the "other income" rule in the U.S. model is that classes of income not expressly dealt with in a treaty, such as lottery winnings, are exempt from tax in the source country. They may also be exempt in the residence country, depending on its internal tax rules. Another effect of the "other income" rule is that income from sources not expressly mentioned in the treaty, such as interest or royalties arising in a third country, may only be taxed in the residence state. This latter feature of the "other income" rule is widely accepted.

The majority of U.S. tax treaties follow the U.S. model with respect to the "other income" article. Some U.S. treaties, however, provide that "other income" arising in the source country may be taxed both in that country and in the residence country.[14] In the event that the two countries do tax the "other income," the residence state is required to relieve double taxation by giving a credit for the taxes paid to the source country. This version of the "other income" article is contained in Article 21 of the OECD Model Treaty (2001).

In tax treaties following the UN model, a taxpayer typically wants its income to fall into some category other than the "other income" category. The opposite is true in treaties following the U.S. and OECD models. By making the residual category unattractive to the taxpayer, the UN model reduces the pressure that taxpayers otherwise would put on the definitional boundaries of various income categories. For example, in treaties that exempt "other income" from source taxation but impose a 10 percent withholding tax on interest income, a taxpayer would want to arrange its loan transactions to have income otherwise characterized as interest income be treated as gain from currency exchange. Characterizing the income as exchange gain would give no advantage to taxpayers under a treaty following the UN model, however, because the exchange gain would be taxable in the source country as "other income."

[14] See, e.g., U.S./Australia treaty, Art. 21(2); U.S./Belgium treaty, Art. 22; U.S./Canada treaty, Art. XXII(1); U.S./China treaty, Art. 21(3); U.S./India treaty, Art. 23(3); U.S./Indonesia treaty, Art. 28(1) (providing as a general rule of taxation that a source state may tax income sourced in that country unless the treaty provides otherwise); U.S./Mexico treaty, Art. 23 ("Items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may be taxed in that other State."); U.S./New Zealand treaty, Art. 21; U.S./Portugal treaty, Art. 24; U.S./Thailand treaty, Art. 24(3).

Another advantage of making "other income" taxable in the source country is that opportunities for international fiscal evasion are reduced. Some of the items of income included in the "other income," such as lottery winnings, are nearly impossible for the residence country to tax in the absence of full reporting by the taxpayer. In the source country, however, such income can be subject to withholding or otherwise brought into the tax net.

A third advantage of making the residual category of treaty income taxable in the source state is that it promotes certainty. In countries that follow the U.S. and OECD models with respect to "other income," taxpayers sometimes argue that various types of payments under derivative financial products, such as interest-rate swaps, are exempt from source taxation under the "other income" article. They also invoke that article to claim an exemption for payments received from a partnership or trust. Other exclusions from source taxation of uncertain validity under the "other income" article include prizes, grants, alimony, and compensatory damages. Rather than leave the treatment of these issues to litigation, treaty partners should make them taxable by making the residual category taxable, or they should make them free of tax through an explicit exemption in the treaty.