Tax Treaties

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What Is a Tax Treaty

Nature and Objective of Tax Treaties

- Legal Nature of Tax Treaties
  - Bilateral Agreement Between Sovereign States
  - Generally Relieving Only — They **Reduce** Taxes
  - Some Countries, e.g., France Impose Tax By Treaty
- Effect of Tax Treaties
  - Impact on Individuals Depends on Local Law
    - May be Self Enforcing under Constitution, e.g. , France
    - May Be Supreme Law by Statute, e.g., Canada
    - May Have Complex Relationship to Domestic Law, e.g., US (later in time)

Goals of Tax Treaties

PURPOSE OF INTERNATIONAL TAX TREATIES

- Eliminate or Mitigate Double Taxation in order to:
  - Facilitate Cross-Border Investment and Trade
  - Treat Residents of Different Countries Fairly
- Combat Tax Evasion and Fiscal Fraud Because:
  - International Tax Evasion Gives Improper Incentive to Export of Capital
  - Results in Unfair Treatment of Residents

Tax Treaty Interpretation

TREATY INTERPRETATION GOVERNED BY INTERNATIONAL LAW

- Vienna Convention on Law of Treaties, Art. 31(1): "A treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their *context* and in light of its *object and purpose*."
- OECD and UN Models, Art. 3(2): Meaning of Undefined Terms of Treaty Based on Domestic Law

Competing Model Conventions

MODELS PROPOUNDED BY UNITED NATIONS AND OECD

- OECD Model Is Dominant
  - Initially Published as draft in 1963, First official model published in 1977
  - Another Major Revision in 1992 and Now Revised Frequently (2005 most recent)
  - Supplemented By Detailed Commentary
- UN Model Published in 1981, Revised 2001, 2006
  - Based mostly on OECD Model
  - Modified somewhat to Take Account of Special Issues for Developing Countries

OECD Model

FAVORS CAPITAL EXPORTING COUNTRIES

- Gives Relief for Double Tax By Reducing Tax in Source County
  - Business Income Exempt Unless Foreign Resident has Permanent Establishment in Source State
  - Interest and Royalty Income Totally Exempt and Dividends Partially Exempt
- Also for source taxes imposed according to the treaty, the residence state is required either to give double-tax relief by the exemption or credit method (Article 23A or 23B)
- Assumes Rough Parity in Trade and Capital Flows

United Nations Model

GIVES SOME ADDITIONAL BENEFITS TO SOURCE COUNTRY

- Adopted to Take Account of some Special Circumstances of Developing Countries, especially non-symmetrical trade flows
- Makes It Somewhat Easier for Foreign Person to Have a Permanent Establishment (PE)
- Leaves Reduction in Withholding Rates to Bilateral Negotiations (Usually Allows Higher Withholding Rates)
- Promotes Tax Sparing (but with diminished enthusiasm)

Commentary to Models

OECD AND UN HAVE DETAILED EXPLANATIONS OF MODELS

- Each Article of Model Treaty Explained, Often in Detail
- Legal Status of Commentary Unclear
  - Intended to be *** Official *** Interpretation
  - Commentary Changes to "Update" Existing and New Treaties
  - Countries Register Their Objections to Particular Provision of Model and to Commentary in the Commentary

Organization of Treaties

CHAPTERS IN ALL MODEL TREATIES

Chapter 1: Scope

Chapter 2: Definitions

Chapter 3: Taxation of Income

Chapter 4: Taxation of Capital

Chapter 5: Elimination of Double Taxation

Chapter 6: Special Provisions

Chapter 7: Entry into Force and Termination

Contents of Tax Treaties

OVERVIEW OF MAJOR PROVISIONS IN MODEL TAX TREATIES

- Coverage and Scope
- Business Income
- Employment and Personal Services Income
- Income and Gains from Immovable Property
- Reduction in Withholding Rates
- Other Types of Income
- Fair Dealing and Cooperation

Scope of Tax Treaty

WHEN, WHERE, WHO AND WHAT ARE COVERED

- Time — When Does Treaty Start and End
- Territory Covered
- Persons Covered
- Taxes Covered

Scope of Tax Treaties: Time

WHEN DO TREATIES START AND END?

- Article 29: Entry into force
  - After Ratification by Both Countries and Exchange of Ratification Instruments
  - May Have Different Starting Dates for Withholding Taxes and Other Taxes
- Article 30: Termination
  - Minimum Notice of 6 Months
  - Usually some Fixed Minimum Term (e.g. 5 years)
  - No Maximum Term
  - Treaty may be amended by a new treaty or protocol (i.e., by mutual consent)

Scope of Tax Treaties: Territory

DEFINING THE TERRITORIES OF THE CONTRACTING STATES

- UN and OECD Model Do Not Define the Contracting States
- Many Treaties Define Certain Geographical Limits
  - Continental Shelf (E.g., Off-shore drilling)
  - Territories of States May Be Included
    - Art. 29 of OECD Model Offers Suggested Rules for Extension to Territories If They Levy Substantially Similar Taxes
    - No Similar Rule in UN Model
    - Example — Old Netherlands/US treaty Extended to Netherlands Antilles, a tax haven (now voided by US)

Scope of Treaties: Persons

WHO IS COVERED BY A TAX TREATY

- Article 1: "This Convention shall apply to persons who are residents of one or both of the Contracting States."
- Article 3: Definition of Person — ". . . includes an individual, a company and any other body of persons"
- Article 4: Definition of Resident — person taxable "by reason of his domicile, residence, place of incorporation . . ."

Persons: Interpretative Issues

DETERMINING PERSONS GOVERNED BY TREATY

- Application to Legal Entities — Partnerships? Trusts? Estates? Limited Liability Companies?
- Treatment of Nationals, Especially US Citizens
- Treaty Shopping — *Bona Fide* Residents
- Non-discrimination Article (Art. 24) Applies to Non-Residents; same for Information Exchange (Art. 26)

Resident Tie-Breaker Rules

PROVISION IN ARTICLE 4 FOR DETERMINING RESIDENCY

- Individuals (Art. 4(2)):
  - Permanent Home
  - Center of Vital Interests (if two permanent homes)
  - Habitual Abode
  - Nationality
  - Mutual Agreement Procedure ("shall settle the question")
- Corporations
  - Place of Effective Management
  - Many Treaties Leave to Mutual Agreement Procedure

Scope of Tax Treaties: Taxes

WHAT TAXES ARE COVERED BY A TAX TREATY

- Article 2 — Income and Capital Taxes (Usually Listed Specifically in Para. 3)
- Interpretative Issues
  - What Is Income (or Capital) Tax?
  - Can a Tax Based on Estimated Income Qualify?
  - Taxes Levied by Political Subdivisions Covered
    - Many States do not Accept, Partly for Constitutional Reasons
- Future "Identical or Substantially Similar" Taxes Covered

Taxation of Income

TOPICS COVERED

- Business Income
- Employment and Personal Services Income
- Income and Gains from Immovable Property
- Reduction in Withholding Rates on Investment Income
- Other Types of Income

Treatment of Income by Treaty

GENERAL CONCEPTS UNDER MODEL TREATIES

- Allocation of Power to Tax (Exclusive Right to Tax to Residence State Unless Conditions Met)
  - Business Income and Gains from Business Property
  - Income and Gains from Immovable Property
  - Employment Income
  - Most Other Types of Income
- Limitation on Power to Tax (Both States May Tax, But Limitations on Source State)
  - Investment Income

Business/Commercial Income

GENERAL CATEGORIES UNDER UN AND OECD MODELS

- Industrial and Commercial Profits (Art. 7/5)
- Independent Personal Services (UN, Art. 14; OECD, Art. 7/5)
- Shipping and Air Transportation (Art. 8)
- Artistes and Sportspersons (Art. 17)

Business Profits: Article 7

GENERAL APPROACH

- Taxable in Source Country Only If Permanent Establishment (PE)
- Income Must be Attributable:
  - to PE (OECD Model)
  - to PE, or to Sales or Business Activities of "same or similar kind" (UN Model)
- Interest, Dividends, Royalties, and Gains Derived from PE Are Taxed under Art. 7

Definition of PE — Art. 5

GENERAL RULE: FIXED PLACE OF BUSINESS

- A "fixed place of business through which the business of an enterprise is wholly or partly carried on" (Art. 5(1))
- Generally includes, But Not Limited to (Art. 5(2)):
  - place of management; branch; office; factory; workshop;
  - mine, an oil or gas well, a quarry or any other place of extraction of natural resources

More On PE Definition

Some of the Special Rules for Defining a PE

- Building Site or Construction Project is PE:
  - 12 Months Minimum Stay Required in OECD Model
  - 6 Months in UN Model
- UN Model Also Makes Supervisory Activities in Connection with a Construction Project a PE
- UN Model Makes Furnishing of Consultancy and Other Services Through Employees or Other Workers a PE if Continued for 6 Months

Agents Constituting a PE

Activities of an Agent Can Be a PE of Principal

- Dependent Agent Rule
  - ***OECD Version:*** Enterprise Has a PE If It Has a Dependent Agent in Source State and Agent Has Power to Conclude Contracts Habitually Does So
  - ***UN Version:*** Same as OECD Except that Agent is Also a PE If It Has a Stock of Goods from Which It Regularly Delivers Goods on behalf of the Enterprise.
- Independent Agent Rule — Not a PE if the Agent Is Independent and Acting in Ordinary Course of Its Business (e.g., UPS, FedEx, stock broker)

Additional PE Rules

CERTAIN RULES PREVENTING THE CREATION OF A PE

- A Corporation Does Not Have a PE Solely Because It Controls an Affiliated Company that Has a PE
  - If the Affiliated Company Acts as the Agent for the Corporation, It May Have a PE under the Agency Rule
- Specific Exclusions Are Provided for Certain Auxiliary or Preparatory Activities
  - Examples Include Storage Facility, Display Facility, Purchasing Office and Information Collection Office

Attribution of Income to PE

ASSIGNING BETWEEN A PE AND REST OF ENTERPRISE

- Business Profits of Enterprise Taxable in the Source State Only If Attributable to PE
- Arm's Length Principle of Art. 9 Applies
- Related Expenses Generally Deductible in Determining Profits of PE
  - UN Model Generally Does Not Allow Deduction for Payments Above Cost to Head Office for Use of Intangible Property, for Management Services, etc.

Shipping, Etc.: Article 8

SHIPPING, AIR TRANSPORT

- *General Rule*: Profits from Operating Ships and Aircraft in International Traffic Are Taxable Only in the Country Where the Enterprise Has its Place of Effective Management
  - UN Model Has Alternative Provision That Would Allow Source Taxation of International Shipping Profits If the Activities in the Source State Giving Rise to the Profits Are "more than casual"
- Definition of International Traffic in Article 3

Associated Enterprises

ARM'S LENGTH STANDARD SUGGESTED IN ARTICLE 9

- *General Rule*: If Associated Enterprises do not deal as Independent Enterprises, the profits that they would have made if they had done so may be added to their profits and taxed accordingly (*arm's-length standard*).
  - Two Enterprises are "associated" if one participates directly or indirectly in the management, etc. of the other or third person participates in both enterprises
  - Two Enterprises are not dealing as independent enterprises if conditions made or imposed differ from those of independent enterprises

Investment Income

Types Under UN and OECD Models

- Income from Real Property (Art. 6)
- Dividends (Art. 10)
- Interest (Art. 11)
- Royalties (Art. 12)
- Capital Gains (Art. 13)
- Pensions and Annuities (Mixed Investment and Personal Services Income) (Art. 18)

Immovable Property: Article 6

Income Derived from Real Property

- Taxable without limit in source country
- Includes rent, sales income, income from farming, forestry and natural resources
- Immovable property generally defined by reference to law of country where property is located

Dividends: article 10

Dividends constituting investment income

- Taxable in residence state and source state
- Dividends to parent companies
  - under OECD model, maximum withholding rate in source state is 5%
  - under un model, maximum rate to be negotiated
  - "parent company" must own at least 25% of capital (OECD) or 10% of capital (un)
- Withholding on other dividends
  - capped at 15% in OECD model
  - cap to be negotiated in un model
  - recent trend is 0% for 80% or more affiliates

Interest and Royalties

Articles 11 & 12

- Interest
  - Taxable in residence state and source state
  - Rate capped at 10% in OECD Model
  - Rate cap to be negotiated in UN Model
- Royalties
  - Exempt under OECD Model (0% Rate)
  - Rate Capped in UN Model, with rate to be negotiated
- Dividends, interest, and royalties attributable to business conducted through PE taxable as business profits

Capital Gains: Article 13

INCOME DERIVED FROM SALE OF ASSETS

- Gains from alienation of immovable (real) property taxable by Source Country
  - UN Model Specifically Permits Tax on Gain from Sale of Shares of Real Estate Holding Company, Trust, or Partnership
- Gains from Movable Property That Is Part of PE or Fixed Base Taxable in Source State
- Gains from Alienation of Ships and Aircraft Taxable Only in State Where Place of Effective Management Is Situated

Other Capital Gains

TAXATION OF CAPITAL GAINS NOT ENUMERATED

- Gains from Alienation of Property Not Specifically Referenced in Art. 13 ("Other Gains") Generally Taxable Only by Residence State
- UN Model has Special Rule Allowing Source State to Tax Gain on Sale of Stock of Resident Corporation if Ownership Percentage (to be Negotiated) is Met
- Term "Capital Gain" Not Defined By Treaty

Pensions: Article 18

INCOME PART EMPLOYMENT, PART INVESTMENT

- OECD: Pension Paid to Resident of State Only Taxable by Residence State
  - Exception — Government Pensions May Be Taxed by Government Making Payments (Art. 19(2))
  - Not Applicable to Self-Employment Pensions
- UN: Two Alternatives
  - ***Alternative 18A***: Same as OECD Except Social Security Payments May Be Taxed Only by Payer State
  - ***Alternative 18B***: Same as Alternative 18A Except that Pensions May Also be Taxed in Source State if Paid by a Resident or PE of Source State

Income from Personal Services

INCOME DERIVED FROM LABOR OF INDIVIDUALS

- Independent Services (Art. 14 UN, Art. 7 OECD)
- Dependent Personal Services (Employment) (Art. 15)
- Directors' Fees (Art. 16) and top executives (UN)
- Artistes and Sportsmen (Art. 17) (taxable in Source Country)
- Pensions (Art. 18)
  - Typically a Mix of Payment for Past Services and Investment Income
- Government Service (Art. 19)

Independent Personal Services

ARTICLE 14 IN UN MODEL, OMITTED FROM OECD MODEL

- Art. 14 Applies to "professional services or other activities of an independent character"
- Income Taxable by Residence Country
- Also Taxable by Source Country If *Fixed Base* Is Regularly Available and Income Is Attributable to that Fixed Base
- Art. 14 Removed from OECD Model in 2000
  - Professional and Similar Services Now Taxable under Arts. 5 and 7 as Business Profits

Employment: Article 15

WAGE INCOME OF EMPLOYEES AND DEPENDENT AGENTS

- Taxable in Country Where Employment Exercised and in Country of Residence
- Exemption from Source Country Tax If:
  - Employee Is Present for No More Than 183 Days **AND**
  - Remuneration Paid by Nonresident Employer **AND**
  - Remuneration "Not Borne by" Employer's PE
  - Note: Some Treaties Put Cap on Remuneration
- Special Exemption for Employment in International Traffic or Inland Waterway

Directors' Fees: Article 16

Payments to Directors and Top-Managers

- Directors' Fees Paid to a Resident of a State by a Company Resident in the Other Contracting State May be Taxed in that Other State
  - Place of Performance of Services Does Not Matter
- Under UN Model, Remuneration Paid to a Top-level Manager Resident in the Other Contracting State May Be Taxed in That Other State.
  - Under OECD Model, Those Payments Would Be Governed By Art. 15 (Dependent Personal Services)

Entertainers, Etc.: Article 17

Income Derived by Artistes and Sportspersons

- Remuneration from Personal Activities as an Entertainer or Athlete Fully Taxable in Country Where Such Activities Are Performed
  - OECD and UN Commentaries Define Artistes and Sportspersons Broadly
- Art. 17 Applies to Individual or Any Other Person Acting on His Behalf (Such as a Company Owned by Individual or Related Persons)
- Overrides Arts. 14 and 15 (Dealing with Personal Services)

Government Service: Article 19

Received by Employees of Contracting State

- Remuneration Paid to Public Servants Generally Taxable Only by Country to Which Services Were Rendered
  - Excludes Remuneration Paid to Nationals of Other Country and Locally Engaged Staff for Services Rendered in Other Country
  - Government Pensions (Including Social Security Benefits) Taxable Only by Paying Country Unless Paid to a Resident and National of Other Country
  - Rules Do Not Apply to Payments in Connection with a Trade or Business

Students: Article 20

Scholarships, etc., Payments to Foreign Students

- Visiting Students and Business Apprentices Exempt from Tax on Maintenance Payments and Tuition Fees Paid from Foreign Sources
  - Narrow Rule that Conforms with Domestic Laws of Many Countries
  - Applies to Students Who Were Resident of a Contracting State and Gave up Residence to Study in Other State
- Many Tax Treaties Have Broader Rule
  - Some Include Exchange Teachers and Researchers

Other Income: Article 21

TREATMENT OF INCOME NOT MENTIONED IN OTHER ARTICLES

- OECD Rule: The Resident State Has Exclusive Right to Tax Other Income of Its Residents Unless the Resident Has PE in the Source State and the Income Is Effectively Connected with that PE
- UN Rule: Same as OECD Except that the Source State May Also Tax If the Income Arose in the Source State (Note: Major Exception)

Examples of Other Income

LONG LIST

- Income from Real Property in a Third Country
- Dividends, Interest, and Royalties from Third Country
- Income from Trust or Estate
- Prizes, Award, and Grants
- Alimony and Maintenance
- Social Security Pension (Sometimes)
- Currency Gains and Losses
- Quasi Interest Amounts (E.g. Original Issue Discount)
- Penalties and Tort Awards
- Technical Assistance Payments

Double Taxation: Article 23

Relief by Residence State for Double Taxation

- Article 23A: Exemption Method
  - Residence State Exempts Its Residence on Income Taxable in Source State under Treaty
- Article 23B: Credit Method
  - Residence State Gives Credit (with Limitations) for Taxes Paid in Source State
  - Developing Countries Typically Bargain with Developed Countries for "Tax Sparing" Credit to Make their Tax Incentives More Effective

Nondiscrimination: Article 24

Contracting States Agree Not to Discriminate

- Discrimination on the Basis of Nationality Precluded
- PE of Nonresident Must Be Treated No less Favorably than Domestic Enterprise
- Amounts Paid to Nonresident Deductible on Same Basis as If Paid to Resident
- Discrimination Against Domestic Enterprises Owned by Nonresidents Prohibited

Mutual Agreement: Article 25

PROCEDURE FOR REPRESENTATIVES OF STATES TO REACH AGREEMENTS

- Procedure for Resolving any Disagreement Arising out of the Implementation of the Treaty
- Procedure Calls for Meeting of "Competent Authorities" of Two Contracting States
- Common Focus Is on Transfer Pricing Conflicts
- May Also be Used to Resolve Disagreements over Treaty Interpretation or over Facts on which Tax Liability Is Based
- New issue: Mandatory Arbitration

Exchange of Information

GETTING TAXPAYER INFORMATION FROM TREATY PARTNER

- Exchange of Information concerning Taxes Covered by the Convention (Art. 26)
  - For Carrying out the Provisions of the Convention, **or**
  - For Enforcing Domestic Laws of a Contracting States
  - UN Model Makes Clear that Information to Prevent Tax Avoidance May Be Exchanged
- Valuable Means of Preventing Tax Evasion
- Not Restricted by Article 1 — May Include Information about Non-residents.
- New Development — end of bank secrecy in OECD Model and under discussion for UN Model.

More on Article 26

EXCHANGE OF INFORMATION AGREEMENT

- In General, Information Obtained Must Be Kept Secret
  - Disclosure to Tax Authorities Involved in Assessment, Collection, and Enforcement of Taxes Permitted
  - Disclosure to Courts Permitted
- Information May Be Exchanged:
  - On Routine, Automatic Bases (e.g., Dividends and Wages Paid to Residents of Other State)
  - By Specific Request of Other Contracting State
  - On Initiative of Other State

Assistance in Collection

NO PROVISION IN OECD OR UN MODELS

- Useful for Treaty Partners to Give Assistance in Collection.
- OECD & Council of Europe Convention on Mutual Assistance in Tax Matters (1988, 1995) Provides for Collection and Service Assistance.
  - Ratified by the Nordic Countries plus the Netherlands, Poland, US, UK (15 total).
- US/Canada Treaty (1995) Provides for Taxes to Be Collected By Other Country As IF Owed to It.

Limitation on Benefits

Restrictions to Prevent Treaty Shopping

- No Provision in OECD or UN Models to Combat Treaty Shopping (but recently added to OECD Commentary)
- US Insists on Anti-Treaty Shopping Provision
- Anti-Treaty Shopping Rules Are Designed to Prevent Residents of Third Countries from Obtaining Unintended Benefits:
  - Rules Limit Benefits to *Bona Fide* Residents of Contracting States
  - "Base Erosion" Prohibited to Prevent Use of Resident Entity as Conduit for Benefit of Third Parties

Current Issues

Topics under Discussion

- E-Commerce (OECD position is taxation ONLY in residence country (or nowhere).
- Hybrid Entities (Used, for example to get a double deduction or obtain treaty benefits improperly.
- New financial instruments (e.g., derivatives)
- Responses to harmful tax competition.
  - End of bank secrecy in treaties.
  - Spread of assistance in collection.
- Computing income of a branch (arm's length analogy by OECD).
- CFC legislation.
- Mergers and Acquisitions

The End