International Tax Treaties
Prof. McIntyre, Fall 2003
Notes on the Answers

Question 1

(1) **Not taxed**. The dividend may not be taxed by Country K under Article 21 (Other Income) of the UN treaty, which limits the right to tax "Other Income" by the nonresident state to income arising in that state.

(2) **Taxed**. Gambling winnings are "other Income" and may be taxed in the nonresident state under Article 21(3) of the UN model if they are source there, which they are in this case.

(3) **Not Taxed**. The income is processional services income, governed by Article 14. Under Article 14(1) of the UN model, it is taxable exclusively in the residence state (Country J) because Miss J does not have a fixed base in Country K to which the income relates. Article 21 (Other Income) is not applicable because the income The income has a foreign source, and so is not reached by Article 21(3) and is dealt with in another article. In any event, Article 21(3) is not applicable because the income has a foreign source.

(4) **Taxed**. The income is employment income, governed by Article 15, unless some other provision controls.. That article give the exclusive right to tax to the residence state "unless the employment is exercised in the other Contracting State." Here, the income was exercised in a third country. Article 16 (Directors' Fees and Remuneration of Top-level Managerial Officials), however, allows Country K to tax the income of top-level management of a resident of Country J if the remuneration is paid by KCo, a resident of Country K, without reference to the country of source of the income. Presumably a "high-ranking" employee (language in the question) and a "top-level" employee (language in the treaty) are essentially equivalent.

Question 2

2a. Unclear (to me) whether PCo has a PE in Country L, but I'm inclined to say "yes." A PE is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." There are three arguments that PCo has a PE, none fully convincing.

(1) The plant which it owns could be a PE. Clearly it is a fixed place of business. the question is whether PCo carried on business at that location. I think it probably did, though its agents, NCo and TCo. PCo's business in Country L was to construct a turnkey plant, which was accomplished at the plant by persons acting on behalf of PCo.

(2) TCo could be treated as the PE of PCo. The fact that PCo owns the stock of TCo is not enough under Art. 5(7). It is unlikely that TCo has authority to conclude contracts for PCo. The Country L tax authorities would have to argue that TCo is really a sham, and that is generally a losing argument.

(3) NCo could be treated as the agent of PCo. We need more facts to determine whether NCO has authority to conclude contracts for PCo. My assumption is that NCo is operating as an independent party, responsible for the end product. If so, then it is not a dependent agent of PCo.

2b. NCo does not have a PE in Country L. The treaty between Country N and County L provides that a construction site is not a PE if it does not last for at least 18 months. The plan is for the construction to be done in 12 months. Of course, if the project gets delayed by 6 months, then the construction site would be a PE. I see no other ground for claiming that NCo has a PE.

2c. The treaty between Country L and Country P is based on the OECD model for purposes relevant to this question. Article 13(1) (Capital Gains) provides that the source state may tax gains arising from the sale of immoveable property, which is essentially equivalent to real property. So the gain from the sale of the plant is taxable by Country L under that article. PCo also may have some moveable property, such as equipment in the plant. The gain from the sale of that equipment is taxable in Country L under Article 13(2), if the plant is a PE. See answer to subquestion 2b. If the plant is not a PE, then the gain on the sale of the equipment cannot be taxed in the source country under Article 13(4) or any other article.

2d. PCo's profit of $20 million is due primarily to its sharing of its trade secrets and patents with LCo. There is not much gain on the same of the plant itself, since PCo paid NCo the market price to build the plant. And there is not much gain on the training of employees of LCo because PCo paid TCo the market rate for the workers plus 20 percent. Thus, in substance, PCo is being paid a lump sum for its technology. Article 12(2) (Royalties) defines a royalty to include "payments of any kind." So I conclude that, in substance, mush of the $20 million of profit is a royalty, taxable in Country L at a rate of 10 percent. However, PCo cannot repudiate the form of its own transaction to get that result. Assuming no capital gains preference for corporations, therefore, PCo will be taxable on its capital gains at a rate of 40%.

I see no scope for considering any of the income "other income." Nor do I see PCo as receiving interest income. On the contrary, it has received an interest-free loan, which Country L can recast as a loan with interest. Assuming unstated interest of $2 million, Country L should increase the contract price to $42 million and give PCo a deduction for $2 million of interest. For taxing capital gains, this change does not matter, but it does if the transaction is treated as one generating a royalty for purposes of Article 12. The reason is that the withholding rate on royalties applies to gross income, not net income.

2e. Because PCo has excess foreign tax credits in country P, it should try to make sure its income is foreign source income. It also should try to minimize its foreign taxes. The most obvious flaw in the plan is that PCo probably ends up with all, or almost all, of its income being taxed by country L at full rates as capital gain. This outcome is about as bad as it could be. A better plan would be to make for the form fit the substance and treat the payments as royalties. for purposes of Article 12. That step gets the rate down to 10 percent. In addition, the "loan" should be recharacterized as an advanced payment of the amount due, so as to avoid the problem of imputed interest and the grossed-up royalty, discussed in 2d, above.

There is no need for PCo to use a tax haven because Country P is, in effect, a tax haven, due to the excess credits that PCo has accumulated from activities unrelated to the activities in Country L.