

International Taxation

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Cross Border Trade

- direct sales from country of residence
- via independent sales agent (commissioner)
- via dependent sales agent
- via permanent establishment - branch
- via subsidiary company

Complication: electronic commerce

Cross Border Investment & Business

- equity investment for gain or dividends
 - debt investments for interest
 - exploitation of IP
 - leasing / rental
- immovable and movable property
- service fees
- etc ...

Scope of International Tax Law (M. 1)

1. Domestic legislation covering
 - a. foreign income of residents ("world income")
 - b. domestic income of non-residents
2. Domestic legislation and treaty provisions relieving cross-border double taxation
3. Domestic legislation and treaty provisions containing rules against cross-border tax avoidance and evasion
4. Supra-State law (e.g. EU) and jurisprudence

Scope of Our International Tax Studies

- Treaties and Conventions
- Practice of States (i.e. domestic law)
- Intra-Governmental Organizations
(i.e. OECD Documentation)
- EU and other jurisprudence
- Scholars

INTERNATIONAL ORGANIZATIONS AND TAXATION

European Union	*	council of ministers
	*	commission: - directive proposals - actions against Member states
	*	court of justice
OECD	*	council of ministers
	*	committee on fiscal affairs
United Nations	*	economic and social council (Ecosoc)
	*	ad hoc group of tax experts

WTO; IMF; CIAT; CATA; IFA; IBFD

What is a Treaty (M. 2)

A tax treaty is an agreement between two States to limit the exercise of their respective taxing jurisdiction and provides a mechanism for bi-lateral engagement between the competent authorities.

Types of DTAs

- Bilateral > 3,000
- Multilateral Nordic Tax Convention
- Comprehensive (income + capital)
- Limited inheritance and gift tax
TIEA
- Non-tax - Shipping + air transportation
- Investment Protection treaties

Interpreting a DTA m. 2

- The Vienna Convention on the Law of Treaties.
- The OECD Commentary.
- The definitional rule of the OECD Model.

Objectives of DTAs

- 1) Preventing international juridical double taxation
 - ❖ via limiting taxing rights in source state, and
 - ❖ avoidance of double taxation to be applied in residence state
- 2) Preventing economic double taxation (in transfer pricing matters, Art. 9 Para. 2)
- 3) Preventing discrimination in tax matters (Art. 24)
- 4) Preventing tax avoidance
 - ❖ Limiting tax benefits (beneficial owner; LOB-provision – U.S. Treaties)
 - ❖ Cooperation between tax authorities (Art. 26)
- 5) Stimulating investment in developing countries (via tax sparing credit)
- 6) Protection of taxpayers – mutual agreement procedure (Art. 25)

OECD Model structure

Scope (Article 1 and 2)

- Convention applies to tax resident or one both Contracting States.
- Deals with taxes on income and capital.

Definitions (Articles 3 to 5)

- Terms used in more than one article are described (e.g resident).
- Other terms defined in specific articles (e.g immovable property).

Allocation of rights to tax

Taxation of income and capital (Articles 6 to 22):

- Respective rights to tax different classes of income are assigned to the State of source (S) and to the State of residence (R).
- Income & capital classified into 3 classes:

Class1. May be taxed without limit in S.

Class2. Income may be subjected to limited taxation in S.

Class 3. Income and capital may not be taxed in S.

Source taxation of non-residents

Class 1: U n r e s t r i c t e d t a x a t i o n

- income from immovable property located in source state
- profits of a permanent establishment, located in source state, of foreign enterprise
- [income from employment in source state if longer than 182 days or cost borne by source state

Class 2: R e s t r i c t e d t a x a t i o n (via withholding tax)

- dividends paid by a company residing in source state to foreign beneficiary
- interest paid to foreign creditor

Source taxation of non-residents

Class 3: No t a x a t i o n

- Business profits not attributable to a PE
- Royalties (OECD)
- Gains from alienation of shares
- Private sector pensions
- income from employment in source state if less than 183 days and cost not borne in source state

DOUBLE TAXATION : Two types

Juridical: if one person is taxed twice on same income

- w/h tax and company tax on repatriation of dividends
- tax on PE income and taxed again in head office tax base

Economic: if more than one person is taxed on the same income

- company and shareholder
- transfer pricing adjustments

COMPARISON

<u>CLASSICAL SYSTEM</u>	<u>FULL IMPUTATION</u>	<u>EXEMPTION</u>
taxable profit 100	taxable profit 100	taxable profit 100
corporation tax 40% <u>40</u>	corporation tax 40% <u>40</u>	corporation tax 40% <u>40</u>
net profit <u>60</u>	net profit <u>60</u>	net profit <u>60</u>
dividends received by indiv. shareholders 60	dividends received by indiv. shareholders 60	dividends received by indiv. Shareholders 60
income tax 50% <u>10</u>	<u>30</u> (calculation of income tax 50%): attributed profits <u>100</u> income tax on attrib. profits 50 less corporation tax <u>40</u> --- net income <u>30</u>	income tax 0
total tax 40 + 30 =	total tax 40 + 10 =	total tax
	<u>70</u>	<u>40</u>
		income tax <u>40</u>

Taxation of dividends from resident companies received by individuals

Austria	: Mitigated classical; final WHT of 25%
Belgium	: Mitigated classical; final WHT of 25% or 15%
Denmark	: Mitigated classical; reduced rate of income tax of 28% or 43%
Finland	: Mitigated classical; flat rate of income tax of 29%
France:	: Imputation (50% of the net dividend)
Germany	: Mitigated classical; only 50% of dividend is taxed
Greece	: Exemption
Ireland	: Classical
Italy	: Imputation (full)
Luxembourg	: Mitigated classical; only 50% of the dividend is taxed
Netherlands	: 30% tax on a deemed return of 4% of the average value of the shares

Taxation of dividends from resident companies received by individuals

- Norway: : Imputation (full)
- Portugal : Mitigated classical: only 50% of the dividend is taxed
- Spain : Imputation (40%)
- Sweden : Mitigated classical; exemption for dividends from qualifying small companies
- U.K. : Imputation (1/9); income tax rates of 10% (dividend under GBP 29,900) or 32.5% (over)

Terminology Chapter III OECD Model

- A. “Shall be taxable only”; exclusive right of residence state.
e.g. Art. 7, Business Profits (unless a **P.E.** in source state), Art. 8 (shipping), Art. 12 (royalties), Art. 21 (other income)
- B. “May be taxed” in source state: unrestricted right of source state (normal domestic rate), e.g. in Art. 6 (immovable property), Art. 7 (**P.E.** in source state), Art. 13 (cap. gains) etc.
- C. “May be taxed” in both source state and residence state:
restricted right to tax for source state:
via withholding tax with ceiling, Art. 10 and 11
- N.B. Residence state may always include income originating in source state in taxable base provided that it applies method for avoidance of double taxation

Scope of Tax Treaty

Article 1, Persons covered:

- persons who are residents of one or both of the contracting states

Article 2, Taxes covered:

- income and capital (irrespective of government level)
- notion of income and capital broad
- the existing taxes at time of signature
- also any identical or substantially similar taxes imposed after the signature
- notification of significant changes

Partnerships

A. Tax Treatment

- Treated as a corporate entity (e.g. Spain, Belgium)

Consequences: * partners are taxable when income is actually received

* income qualified as dividend (Art. 10)

- Treated as a transparent entity (e.g. Germany, The Netherlands)

Consequences: * partners are immediately taxable for their share in the profit, whether or not paid out

* income qualified as business income (Art. 7)

Partnerships (continued)

- B. Consequence of different treatment, e.g.
- | | |
|-----------------------------|------------------------------------|
| partnership in Netherlands: | partner residing in Spain: |
| domestic partner taxable | income from partnership |
| on profit share | only taxable if received (Art. 10) |
| partners residing abroad | |
| are not taxable | |
| (unless P.E. in NL) | |
| (Art. 7) | |

Consequence: Spanish partner not taxable if profits are not distributed but accumulated in partnership

- C. Entitlement to treaty benefits?
- Art. 1, 3 and 4
 - Taxable entity / transparent entity not taxable as such

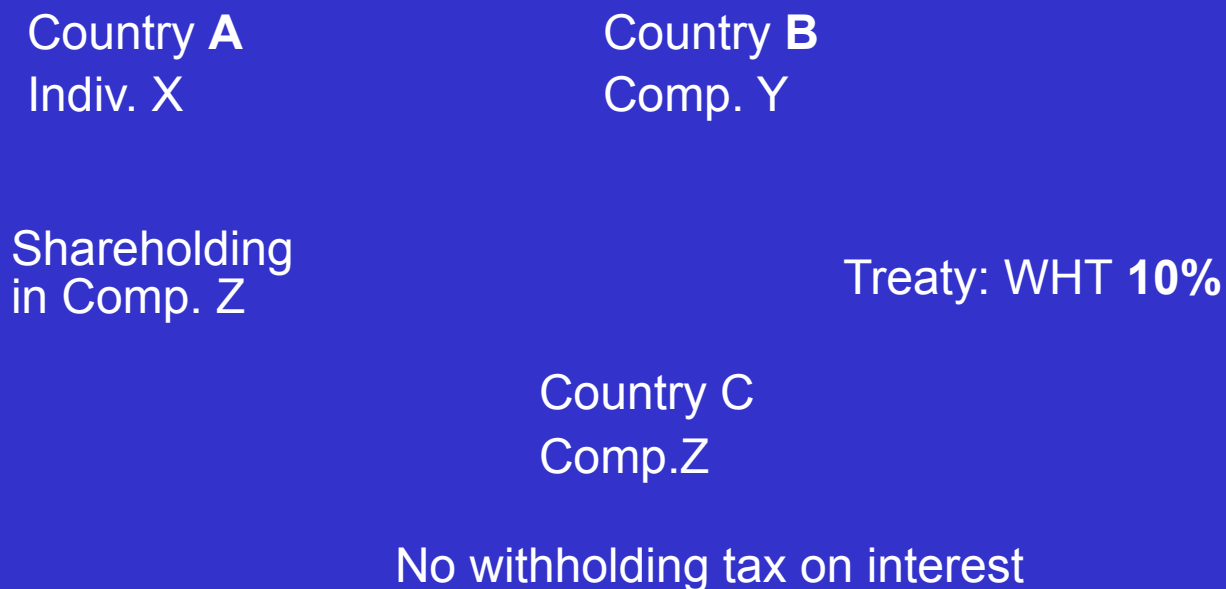
Intermediary Use of Convention

A. Original Situation

No treaty



B. Situation after tax planning



Remedy: “Beneficial owner” concept (Art. 10,11,12)

Problem: Exchange of information is still limited

Interpretation of Tax Treaties Chapter II OECD Model

* Art. 3 OECD Model: Six definitions (including person, company)

Art. 4 “ : Definition of resident

Art. 5 “ : Definition of PE

Art. 10-11-12 ” : Definitions of dividends, interest, royalties

* Terms not defined: e.g. control (art. 9)
beneficial owner (art. 10, 11 ,12)
capital gains (art. 13)

* Art. 3, Par. 2, OECD Model:

Any term not defined shall have meaning under domestic tax law unless the context otherwise requires

* Vienna Convention on the law of treaties 1969

Article 31: Ordinary meaning in context and in light of object + purpose

Article 32: If result of Art. 31 is ambiguous, obscure, absurd or unreasonable: supplementary means of interpretation

Art. 4, Residence

- A. Crucial concept for application of tax treaties
 - * Only residents are entitled to treaty benefits
 - * Reference to definition in domestic tax law, but
 - * Only full tax liability is sufficient

- B. Collision rules in § 2 + § 3:
Double taxation as result of dual residence avoided.

- C. Residence of companies:
 - * Place of effective management is most important criterion (Art. 4, § 3)
 - * Subordinate criteria: - State of incorporation
 - Statutory seat

- D. Place of effective management:
Place where the important decisions are taken and where implementation is coordinated.

Art. 5, Permanent Establishment

Art. 7: Business profits shall be taxable only in residence State **A** of enterprise unless enterprise has PE in the other State **B**

Art. 5, § 1: Gives definition of PE:

Fixed place in State B through which the business of an enterprise of State A is carried on.

- * Place of business: some physical presence (premises, equipment)
- * Place must be fixed: certain degree of permanence at a distinct place
- * Business must be carried on through fixed place.

Art. 5, § 2:

- * Non-exhaustive list of examples
- * Criteria of § 1 remain decisive

Art, 5, § 3: Building sites and construction projects are PE only if they last more than 12 months

- * Term starts when preparatory work “on site” starts
- * 12 month period applies to each individual site or project

Art 5, Permanent Establishment

Art. 5, § 4: Which activities do not constitute a PE?

- * Use of facilities only for storage, display or delivery of goods (if actual selling takes place: always **PE**)
- * Maintenance of stock of goods only for storage, display or delivery
- * Maintenance of stock only for purpose of processing by another enterprise
- * Only purchasing of goods or collecting information
- * Other activities of preparatory or auxiliary character (“PAC” activities)
- * Place of business solely for combination of previous points

If activity is essential and significant part of enterprise as a whole:
Not “PAC” activity!

If activity of fixed place is same as main activity of enterprise:
Not “PAC” activity!

After-sales service: Not “PAC” activity

Activity performed for third parties: Not “PAC” activity!

Art. 5, Permanent Establishment

Art. 5, § 5 + 6: Does an agent constitute a **PE**?

- A. Independent agent in ordinary course of his business > not **PE**
- B. Dependent agent (legally/economically dependent) with authority to conclude contracts in name of enterprise: constitutes **PE** unless he only undertakes activities of § 4.

Art/ 5, § 7: Subsidiary company is independent legal entity which does not constitute PE of parent.

Electronic Commerce

Country A

Selling
Company X
PC



Country B

[Company Y] Server

Hosts	Connection to
Websites	internet

Customer PC

- * Is website a PE of the seller?
- * Is the server PE of the seller?
- * Is company Y a dependent agent of the seller?

Article 7: Business Profits

Country A

Company X

Group Y

Head office

Parent

Art. 7

Art. 7

Art. 10, 11, 12

Country B

PE

Subsidiary

Art. 7

Company X is non-resident
taxpayer in Country B

Subsidiary is resident
in Country B

Article 7, Business Profits

Business Profits: * Only taxable in residence state of enterprise

* Unless **PE** in other state

OECD Rule: No force of attraction:

Only income connected with **PE** may be allocated to PE

U.N. Model: Attraction by **PE** if same activity in source state

Some developing countries: Force of attraction; non-PE-related income in source state is allocated to **PE**

Article 7, Business Income

Primary Approach:

Fiction of separate entity for allocation of taxable profits (only for allocation!)

Head Office and **PE** deal at Arm's Length (like two independent parties)

Exception: - Interest, royalties and notional profits of management
(cannot be charged between H.O. and **PE**)
- Unless bank (interest)

Deviation: - Goods and fixed assets transferred by H.O. to **PE**:
Profit realized by H.O. when sold by **PE**

Costs - Also costs incurred by H.O. for the purpose of **PE** are deductible with **PE**

Article 7, Business Income

Secondary Approach:

Global Formulary Apportionment

Basis: Total profit of **H.O.** + **PE** (or whole group)

Formula: Turnover/personnel costs/capital invested (weighed)

Example: Total profit 100

Total Turnover	1,000	PE :	500
Total Pers. Cost	200	PE :	100
Total Assets	100	PE :	50

$$\text{Profit } \mathbf{PE} = (650 / 1,300) \times 100 = \mathbf{50}$$

Problems:

- * Does not take into account the actual results of **PE**
- * Cannot take into account local economic circumstances

Article 7 , Business Profits

Dividends/Interest/Royalties

Source/Situs Country

PE Connected

Not Connected

Art. 7
(Corp. Tax)

Art. 10, 11, 12
Withholding tax
(Except royalties)

Residence Country

Article 10: Dividends

1. Dividends are profits distributed to shareholders:
 - officially declared dividends
 - informal (“constructive”) dividends
2. Taxable in residence State **R** of receiver
3. Limited taxation in source State **S**:
 - Max. 15% withholding tax on gross amount (portfolio dividends)
 - Unless company of State **R** holds directly 25% or more of company in State **S**; then: 5% withholding tax (intercompany dividends)

Withholder: paying company or paying bank in State **S**

System: - Immediate reduction to treaty percentage, or

 - Refund to beneficial owner of difference between domestic rate and treaty rule

Article 10: Dividends (continued)

4. Only beneficial owner qualifies for reduced withholding tax
5. Note: Art. 10 only covers tax on paid out dividends, not taxation of profits of the paying company
6. Anti-abuse rules: -- beneficial owner (Art. 10)
-- (not in model) L.O.B. and C.F.C.

Article 11: Interest

1. Interest is remuneration for money lent
2. Taxable in residence State R of receiver
3. Limited taxation in source State S:
Max. 10% withholding tax on gross amount
Withholder: paying debtor
System: reduction of refund
4. Only beneficial owner qualifies for reduced withholding tax
5. Main difference with dividends: interest is deductible

Article 12 : Royalties

1. Royalties are payments for use (or right to use) of:
 - Copyrights of literary, artistic or scientific work incl. films
 - Patents, trademarks, tradenames, designs, plans, secret formulas or processes
 - Know-how (industrial, commercial or scientific experience)

[1977 Model: Also payments for industrial, commercial or scientific equipment]

2. Taxable only in residence state of beneficial owner

Note: many reservations on this article

UN Model: Limited right to tax for source State **S**

Article 15, § 1: Dependent Personal Services

- Main rule (§ 1):

Salaries, wages and similar remuneration taxable only in residence state, unless employment is exercised in the other State;

- In latter case:

- a) Income derived from there may be taxed in other State

- b) Physical presence in other State required

- Conclusion: salaries etc. may be taxed in State where employment is exercised!

Article 15, § 2: Dependent Personal Services

- Article 15 (§ 2) exception to main rule: taxable only in State of residence if three conditions are met:
 - a) recipient of remuneration present in other State for no longer than 183 days in any 12-month period; and
 - b) employer not resident of other State; and
 - c) remuneration not borne by permanent establishment or fixed base of employer in other State

Article 18: Pensions

Private pensions and other similar remuneration for past employment taxable only in State of residence of recipient (government pension: see, however, Art. 19)

Social security not for past employment, not covered by this article (see, however, Art. 21)

No definition of pension:

- a) pre-pension payment?
- b) redemption of pension rights?

Article 21: Other Income

- Sweeping-up clause: all income not dealt with in the previous articles taxable only in State of residence
- Aims to avoid any double taxation
- Exception if income effectively connected to **PE** in the other State

Article 23a: Exemption Method

Without Progression:

Net “world” income	100,000
Exempt foreign income	40,000
Net domestic income	60,000

Tax rate 30%

Domestic tax	<u>18,000</u>
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With Progression:

Tax rate 30% up to 60,000; tax	18,000
Tax rate 50% over 60,000; tax	<u>20,000</u>
Theoretical tax on 100,000: 38,000	(38%)
Effective domestic tax 38% of 60,000	<u>22,800</u>

Note: in tax treaties the condition “if taxed in the source State” is usually not made.

Domestic tax laws usually contain such a condition (e.g. Dutch participation exemption + decree on the avoidance of double taxation 2001).

Article 23b: Credit Method

Full Credit:

Net "world" income	<u>100,000</u>	
Domestic tax 30%	30,000	
Foreign tax levied 40% of 40,000	-/-	<u>16,000</u>
Net domestic tax	<u>14,000</u>	

Note: full credit not applied in practice!

Ordinary Credit:

Net "world" income	<u>100,000</u>	
Domestic tax 30%	30,000	
Foreign tax levied 40% of 40,000 =	16,000	
Domestic tax on foreign income 30% of 40,000 =	12,000	
Credit for lowest amount of the two -->	-/-	<u>12,000</u>
Net domestic tax	18,000	
Total tax	34,000	

Tax Sparing Credit

- * included in many treaties between developing and developed countries (not USA)
- * avoids neutralization of tax incentives in developing countries

Example: (**S** = Source country; **R** = Residence Country)

1. <u>Old Situation</u>	2. <u>Tax Incentive</u>	3. <u>Tax Sparing Credit</u>
Income obtained in S	40,000	40,000
WHT 15% in S	6,000	0
Total income	<u>100,000</u>	<u>100,000</u>
Tax in R 30%	30,000	30,000
Credit -/- <u>6,000</u>	No Credit 0	Tax Sparing <u>6,000</u>
Net tax in R	<u>24,000</u>	24,000
Tax S + R	<u>30,000</u>	Tax R <u>24,000</u>

- * the incentive in 2 only results in higher tax revenue for **R**; in situation 3 the investor benefits from waiving withholding tax in **S**.
- * under exemption system investor immediately benefits from reduction of withholding tax in **S**.

Article 24: Non-discrimination

Forbidden:

- A. More burdensome treatment of nationals of the other State (§ 1)
if in the same circumstances
 - * Main circumstance: residence
 - * A resident and a non-resident of same State are not in same circumstances
 - Different treatment is allowed (except in certain situations in E.U.:
Schumacker Case)
 - B. Less favourable treatment of **PE** of enterprise of other State, than own enterprises if carrying on same activities (§ 3)
 - C. Different treatment of deduction of interest or royalty payments depending on residence of receiver in State of the payer or the other State (§ 4)
 - D. More burdensome taxation of resident enterprise owned by residents of other State (§ 5)
- P.S. These kinds of discrimination are forbidden with respect to any tax (not limited to the taxes covered as mentioned in Article 2).

Article 25: Mutual Agreement Procedure

Taxation not in accordance with provisions of convention:

- * resident may present case to competent authorities of his State
- * within three years from first notification
- * Irrespective of domestic remedies (e.g. appeal to court)
- * Competent authority must try to find satisfactory solution with comp. Authority of other State
- * The time limits in domestic law not applicable

Negative Aspects:

- * No right for taxpayer to be heard
- * Neither time limits nor guarantee of solution (except in European Union: arbitration convention: arbitration also included in certain bilateral tax treaties)

Article 26: Exchange of Information 1

Increasing number of international transactions underlines importance of cooperation between tax authorities

Provision for exchange of information

- to carry out the provisions of the treaty and
- to apply domestic laws
- applicable to taxes or every kind

Secrecy rule – treated as secret in receiving State in accordance with domestic law

Disclosure rule – only to those concerned with tax matters

Limitations on use – only in connection with tax matters

Article 26: Exchange of Information 2

Forms of Exchange

- automatic
- spontaneous
- on request

More Recently

- simultaneous investigations
- joint audit with foreign tax auditor

Obligations on State to provide information

- reciprocity
- - internal laws and practices
- obtained in normal course of administration
- no disclosure of trade secrets

Notification to taxpayer

- Required under domestic law in some countries

European Tax Law

Parent-Subsidiary Directive

- Purpose: avoiding double taxation on profits distributed within EU: no other tax than corporate tax in country of subsidiary
- Qualifying entities: - both companies must have one of the legal forms of annex
(Art. 2, 3 + annex) - companies resident in different member states (no dual residence outside community)
- subject to corporate tax without option
- minimum holding of 25%
- (optional) minimum holding period of 2 years or shorter

European Tax Law

Parent-Subsidiary Directive

Qualifying payments: "distribution of profits"

(Art. 1, 4 and 5)

- regular distributed dividends
- constructive dividends?
- liquidation profits only exempt from withholding tax

European Tax Law

Parent-Subsidiary Directive

- Dividends received: 1) exemption method (dividend not included in taxable income):
- (Art. 4) options:
- refusal of cost deductions relating to holding
 - cost deduction allowed but max. 5% of dividend not exempt
 - decrease in value of shares not deductible from profit of parent
- 2) credit method: - dividend included in taxable income; tax credit for corp. Tax paid by subsidiary on profit concerned
- optional: second-tier credit (if intermediate EU member applies exemption)

European Tax Law

Parent-subsidiary directive

Dividends paid: - 25% holding requirement (lower threshold allowed)

(Art. 5) - no withholding tax

- précompte not covered

- imputation systems not covered

European Tax Law

Merger directive

Purpose: - to postpone taxation on capital gains, normally realised with a merger, to later disposal of assets

- safeguarding the claims of the fisc meanwhile

Conditions: - both companies must have one of the legal forms of annex

- companies resident in different member states

(Art. 1 + 3 - not taxable as resident in non-member state
+ annex)

- subject to listed taxes without option

European Tax Law

Merger directive

Types of transaction:
(Art. 2)

- 1) merger:
 - * transfer of all assets + liabilities by **A** to **B**
 - * **A** dissolved >>> **P.E.** remains
 - * shareholders of **A** become shareholders of **B**

- 2) division:
 - * all assets + liabilities of **A** are transferred to **B** and **C**
 - * **A** dissolved -- **P.E.** remains
 - * shareholders of **A** receive pro rata shares in **B** and **C**

European Tax Law

Merger directive

Types of transaction:
(Art. 2)

3) transfer of

- assets: * **A** transfers "branch of activity" to **B**
- * **A** receives shares in **B** as compensation
- * branch becomes **PE** of **B**

4) exchange

- of shares: * shareholders of **A** transfer majority of voting rights to **B**
- * receive shares in **B**
- * **A** becomes subsidiary of **B**

European Tax Law

Merger directive

System: 1. For mergers, divisions, transfers of assets

(Art. 4, 5, 6, 7 + 9) - roll-over relief: PE continues accounting system

- tax exempt provisions + reserves go to receiving company

- if applicable under domestic law: take over of losses

2. For exchanges of shares

- roll-over relief for shareholders for shares received in exchange

European Tax Law

7. Arbitration Convention

Basis: article 220 (now 293) EU treaty

Objective: removal of double taxation in transfer pricing conflicts

Procedure:

- starting point is mutual agreement procedure
- in case of disagreement after two years of submitting: arbitration committee is set up to give opinion within six months
- tax authorities may agree differently within six months after opinion

European Tax Law

8. Interest/royalty directive

- * In force since 1 January 2004
- * Eliminates withholding taxes on outgoing royalty and interest payments within a group of companies in the EU
- * Achieves equal treatment between domestic and intra EU cross-border payments
- * Eliminates formalities and cash-flow problems

European Tax Law

9. European company (SE) statute

- * regulation adopted 8 October 2001 (+ directive on worker involvement)
- * in force 2004
- * directly applicable in member states
- * SE can be set up by:
 - merging two or more public limited companies from at least 2 member states
 - forming a holding company to hold public or private limited companies from at least 2 member states
 - forming a subsidiary of companies from at least 2 member states
 - transforming a public limited company which has subsidiary in another member state
- * registration of SE in member state of head office; published in ec official journal
- * no special tax regime yet

12. Cross-border Savings Income

Directive 18/7/2001 effective 1 July 2005

- automatic exchange of information
- exception for Austria, Belgium, Luxemburg, Switzerland, some territories:
no exchange of info, but withholding tax of 15% (for 3 years) and 20%
(following 4 years)