International Taxation

2nd part: Double Taxation Agreements

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Double Taxation

Double Taxation

- Legal double taxation:
  same person is taxed in 2 states by comparable taxe
- Economic double taxation:
  2 persons are taxed in 2 states by comparable taxes (eg transfer prices)
- If legal and economic double taxation coincide: triple taxation
  - E.g. dividends:

  taxation of profits in the residence state of company
  taxation of shareholder with dividends in the source state
  taxation of shareholder with dividends in the residence state
- Reasons:
  - Collision of unrestricted (residence rule) and restricted taxation (source rule)
  - Conflicts of qualification

Double Taxation

Double Taxation Agreements (DTA)

- **Tax credit method:** Neutrality of capital export

  Income of investments is taxed with the tax rate of state of residence of investor: no difference if he invests in his own or in a foreign state

- **Exemption method:** Neutrality of capital import

  Income of investments is taxed with the tax rate of the state of investment: no difference if the invested funds come from the state of investment or from abroad

Double Taxation

Double Taxation Agreements (DTA)

- Model Agreements (MA):
  - OECD model agreement and commentary: View of the industrialised countries (equilibrium of capital import and capital export); limitation of source taxation, preference of residence taxation

    Examples:
    - ❖ permanent establishment only if strong links (construction only after 12 months; preliminary activities do not constitute a PE)
    - ❖ Reduction/exclusion of withholding taxes on interests, dividends, royalties
    - ❖ In case of doubt: Taxation in State of Residence (Art. 13, 21 OECD-MA)
    - ❖ Additional remark: EC tax law gives preference to residence rule as well by limitation of withholding tax: parent-subsidiary directive, interest-and-royalty directive
  - UN model agreement/Model Agreement of Andean States: View of less developed countries (capital import prevails): Preference of source taxation
  - US model agreement

Double Taxation

Model Agreements:

- Differences OECD-Model vs. UN/Andean Model
  - Higher source tax
  - “attraction power” of permanent establishment
  - No exemption for royalties
- Most DTA`s follow OECD-model
- Germany: presently DTA`s with 86 states
- Russia: presently DTA`s with 66 states

Double Taxation

Double Taxation Agreement

- Completion of DTA
  - Initialize
  - Signature
  - Consent of Parliament (transformation)
  - Ratification
  - Exchange of ratification documents
- Content of DTA: Text of agreement and Protocol
- Effects:
  - Treaty overriding
    depends on national law (Germany yes, Russia no)
  - Self executing?

Double Taxation

DTA: Interpretation

- Vienna Convention on International Contracts dated 23/5/1969, Art. 31 - 33
- Authentic Interpretation, Art. 31 IV Convention, Art. 25 III OECD-MA
- Ordinary meaning rule, Art. 31 I Convention
- Interpretation using the context of DTA, Art. 31 I, II Convention
- Interpretation according to objectives of DTA, Art. 31 I Convention (principle of efficiency)
- Interpretation using contract history, Art. 32 Convention
- Authentic language, Art. 33 Convention
- Autonomous interpretation, but Art. 3 II OECD-MA
- Influence of the Commentary: retroactive effect?

Double Taxation

DTA: Table of Content

- Scope of DTA, Art. 1, 2
- Definitions, Art. 3 – 5
- Distributive rules, Art. 6 – 22
- Methods of Avoidance of Double Taxation, Art. 23
- Specific rules, Art. 24 – 29
  - Non-discrimination, Art. 24
  - Mutual agreement procedure, Art. 25
  - Exchange of information, Art. 26
  - Final provisions, Art. 30, 31

Double Taxation

Persons covered

- „Person“, Art. 1, 3 I a, b, 4 OECD-MA
    - Individuals
    - Company body corporate
    - Body of persons partnerships
- Residence in one or both of the Contracting States
    - „genuine link“, e.g. domicile, residence, management, nationality
    - Double residence possible
    - Partnerships are „persons“ but not „resident“, therefore not covered by the DTA
- Tie-breaker-rule, Art. 4 II OECD-MA
    - only one residence allowed

Double Taxation

Taxes covered, Art. 2 OECD-MA

- Normally all direct taxes, not VAT/excise duties
- New taxes covered as well

Territory covered

- Normally the territory of the respective state, but exemptions possible:
  - UK: not applicable in Channel Islands, Isle of Man, Gibraltar
  - Denmark: not applicable in Faroer Islands, Greenland
  - US: Not applicable in Puerto Rico
  - France: departments in overseas are included (Martinique etc)

Double Taxation

Distributive rules

- 2 purposes
  - □ Define the source country
  - □ Define which country has the taxing rights
- Basis is unilateral claim of States □ they define what they want to tax, i.e. if in the territory
  - □ Business is carried on, services are performed
  - □ Title passes
  - □ Payer or payee is resident
  - □ Contract is concluded
  - □ Property is located or used
  - □ Owner is resident
- Distributive rules limit this claim

Double Taxation

Distributive Rules

- Complete distributive rules
  - Example: Art. 12 I OECD-MA: „shall be taxable **only** ..“
  - Article concerning methods not applicable
- Incomplete distributive rules
  - Example: Art. 6 I „may be taxed …“
  - Method to avoid double taxation to be derived from method article
  - Art. 23A (taxation right of residence state): Exemption in state of residence, unless sec. 2 applies

    Credit method for dividends and interests (sometimes royalties)
  - Art. 23B: Credit method
  - Application of method depends on actual DTA

Double Taxation

Distributive Rules: Principles

- Priority of source state (strong connection to source state)
  - Situs rule: taxable where the site is situated, Art. 6 OECD-MA
  - Rule of permanent establishment: Business profits, Art. 7 OECD-MA
  - Rule where employment is exercised, Art. 15 OECD-MA
- Taxation by both states
  - Dividends, Art. 10 OECD-MA
  - interests, Art. 11 OECD-MA
- Priority of State of Residence
  - Royalties, Art. 12 OECD-MA
  - All other income, Art. 13 IV, 21 OECD-MA

Double Taxation

Type of Income

- Own regime of 14 schedules of income
- But taxable only if covered by income schedule of national law
- Special income schedules have priority over general schedules:
  Art. 7 VII, but reference back possible
- Attribution of income to a person and calculation of income is subject to national law
  - Allows “double dips”, eg in leasing cases

Double Taxation

Immovable Property (agriculture/ forestry/sites), Art. 6 OECD-MA

- „Immovable property“ includes renting of sites, agriculture and forestry
- Includes accessory property, livestock, equipment
- Meaning as under national law
- Priority over business profits, Art. 6 III OECD-MA
- Taxable in the state where the site is situated

Double Taxation

Business profits, Art. 7 OECD-MA

- „Person covered“ is not the enterprise but the person carrying on the enterprise, Art. 3 I d OECD-MA
- Art. 7 VII OECD-MA: Priority of specific income schedules
- Covers professional services as well (formerly: Art. 14 OECD-MA)
- Taxable in state of residence of entrepreneur
  - But: priority of permanent establishment (in pratice the standard)
  - Includes independent agents
- If exemption method applies, included in calculation of tax progression

Double Taxation

Permanent establishment, Art. 5 OECD-MA

- Fixed place of business
- Through which business is wholly or partly carried out
- At the disposal of the enterprise
- Used with some regularity (6 months?) permanence test
- Art. 5 sec. 3 OECD-MA: explanation or extension?
    - Example: Construction/installation project
- Tendency in OECD to extent notion of “permanent establishment”
- Place of management:
    - One or more places of management?
    - Day-to-day or strategic decisions?
    - Transfer of mind and management

Double Taxation

Permanent establishment, Art. 5 OECD-MA

- Limitation of scope:
  - Construction or installation project has to last more than 12 months (in some DTA: 6 months), even if carried out by a “fixed place of business”, Art. 5 sec. 3 OECD-MA
  - No adding-up of several construction projects
  - Stock of goods and exhibition is excluded, Art. 5 sec. 4 (a-c) OECD-MA
  - Fixed place to purchase goods is excluded, Art. 5 sec. 4 (d) OECD-MA
  - Fixed place of preparatory or auxiliary character is excluded, Art. 5 sec. 4 (e) OECD-MA
- Professional services
  - Eg IT services for a company resident in another state
  - At the disposal of the enterprise?
  - Permanent establishment if work lasts longer than 12 months?

Double Taxation

Permanent establishment, Art. 5 sec. 5 OECD-MA

- Permanent agent constitutes a permanent establishment for enterprise
  - Only if authority to conclude sales contracts
  - Not in case of auxiliary activities
- Exception for independent agents, Art. 5 VI
  - Broker, general commission agents are normally independent agents
  - Other agents:
    - ❖ Independent if personal independency (self-employed, business risk)
    - ❖ Have to act in the ordinary course of their business

Double Taxation

Controlled Companies as permanent establishments

- The mere fact that a company is controlled by or controls a company resident in another state does not make the first mentioned company a permanent establishment of the second named company, Art. 5 sec. 6 OECD-MA
  - Enables the foundation of “control centres”
  - Enables organisation of a international group according to business lines

Double Taxation

Calculation of income of permanent establishment

- No „power of attraction“ of permanent establishment
- „separate enterprise“
  - Relevant business activity? Art. 7 sec. 1 OECD-MA
  - Functionally separate entity? Art. 7 sec. 2 OECD-MA
- No profit allocation for the mere purchase of goods, Art. 7 sec. 5 OECD-MA to be deleted in future DTA’s
- Calculation of income as under national law
- Realisation of profit by sales to permanent establishment? “Dealings”
- Profit element?

Double Taxation

Calculation of income

- Direct method
  - Art. 7 sec. 2 OECD-MA: standard method
  - Limited to „profits of enterprise“ (consolidation of profits and losses)?
- Indirect method
  - In principle applicable, Art. 7 sec. 4 OECD-MA to be deleted in future DTA’s
  - Limited to total profit?
  - Problem to find an appropriate key
- Consistency of methods applied, Art. 7 sec. 6 OECD-MA

Double Taxation

Calculation of Income

- Financing
  - Freedom of financing?
  - Equal financing within the enterprise?
  - Arm‘s-length-financing?
  - Profits and losses arising from currency exchange
- Transfer of assets to perm. establishment
  - Realisation of profits and losses?
  - Deferred taxation?
- Branch profit tax
  - Withholding tax on profit repatriation
  - Comparable to withholding tax on dividends equal treatment of PE and Affiliate

Double Taxation

Calculation of Income

- New OECD-approach: functionally separate entity
- Arm's-length-principle to be applied
- Profit allocation to PE according to:
  - Functions fulfilled
  - Risks assumed
- To be determined according
  - People functions assumed by PE
  - Dealings concluded
- Other documentations

Double Taxation

Taxation of perm. establishment

- Losses
  - Deduction, if no DTA or DTA with credit method
  - Deduction, if exemption method?
- Rules of thin capitalisation
- Rules for CFC‘s
- Rules of documentation of transfers of assets/goods

Double Taxation

Partnerships

- If transparent, DTA does not apply
  - Partnership is not entitled to claim benefits under a DTA
- Constitutes permanent establishment of partners
- Problem: special purpose remunerations
- Problem: Foreign tax credits (OECD Partnership Report)
  - if transparent in both states
  - if transparent in one state only
  - if intransparent in both states
  - three-partite situations: many combinations possible which result in qualification conflicts

Double Taxation

Dividends, Interests, Royalties

- Taxed in state of residence
- Limited right to tax in source state: withholding tax
- Rate of withholding tax limited:
  - Shareholder is company and owns at least 25 % of shares: 5 %
  - Portfolio dividends: 15 %
  - Interests: 10 %
- tax credited in residence state
- Special case: Royalties
- Priority of perm. establishment
- Arm‘s-length principle
- Proviso for treaty shopping: beneficial owner

Double Taxation

Dividends, Interests, Royalties

- Special problem of hybrid loans (loans with profit-related interests)
  - Possible qualification conflict (“white income”):

    State of debtor qualifies as interests

    State of creditor qualifies as dividends
  - In some DTA therefore: qualified as dividends but no limitation of withholding tax if tax deductible in the state of debtor
- EU-directive abolishes source tax within a group of companies
- Germany as source state: No withholding tax on interests (therefore problem of thin capitalisation)

Double Taxation

Capital gains, Art. 13 OECD-MA

- Sites
  - Taxed in state where situated, Art. 6 IV, 13 I
  - Applicable for sites of enterprises as well
  - Applicable for shares of companies whose assets consiss of more that 50 % in immovable property
- Permanent establishments:
  - Profits from business activities Art. 7 OECD-MA
  - Sale of fixed assets resp. of perm. establishment as a whole Art. 13 OECD-MA
- Any other property (shares): state of residence

Double Taxation

Income from employment

- Taxed where the employment is exercised
- But taxed in the state of residence of employee, if
  - Employment in the state where the employment is exercises is less than 183 days, **and**
  - Employer is not resident in the state of employment, **and**
  - Salary is not borne by perm. establishment in the state of employment
- Different rules in different DTA’s
- Eg. presence of more than 183 days during
  - calendar year
  - tax year
  - a running 12 month period

Double Taxation

Other income, Art. 21 OECD-MA

- All income not dealt with in other articles
  - Income from source state not dealt with in Art. 6 ff
  - Income from third countries
  - Income from state of residence
  - Income from areas not part of a state
- Priority of perm. establishments
- If not: Exclusive right to tax of the state of residence

Double Taxation

Non-discrimination clause, Art. 24 OECD-MA

- No discrimination on grounds of nationality; however, unequal treatment due to difference in residence is allowed
- No discrimination of permanent establishments: shall not be less favourably taxed than a resident enterprise
- No discrimination in expense deduction
- No discrimination of foreign ownership: A company resident in a state and owned by residents of the other state may not be less favourably taxed than a company resident in one state and owned by residents of the same state
  - Protects only the company, not the owner of the shares

Double Taxation

Exchange of Information, Art. 26 OECD-MA

- 2 versions:
  - Wide version: exchange of information for all tax purposes (eg avoidance of tax fraud)
  - Narrow version: Only for the purpose of the DTA, i.e. only to avoid double taxation
- Exchange max be on request, spontaneously or automatically
- Restrictions in Art. 26 III OECD-MA
- Information may only be used for tax matters

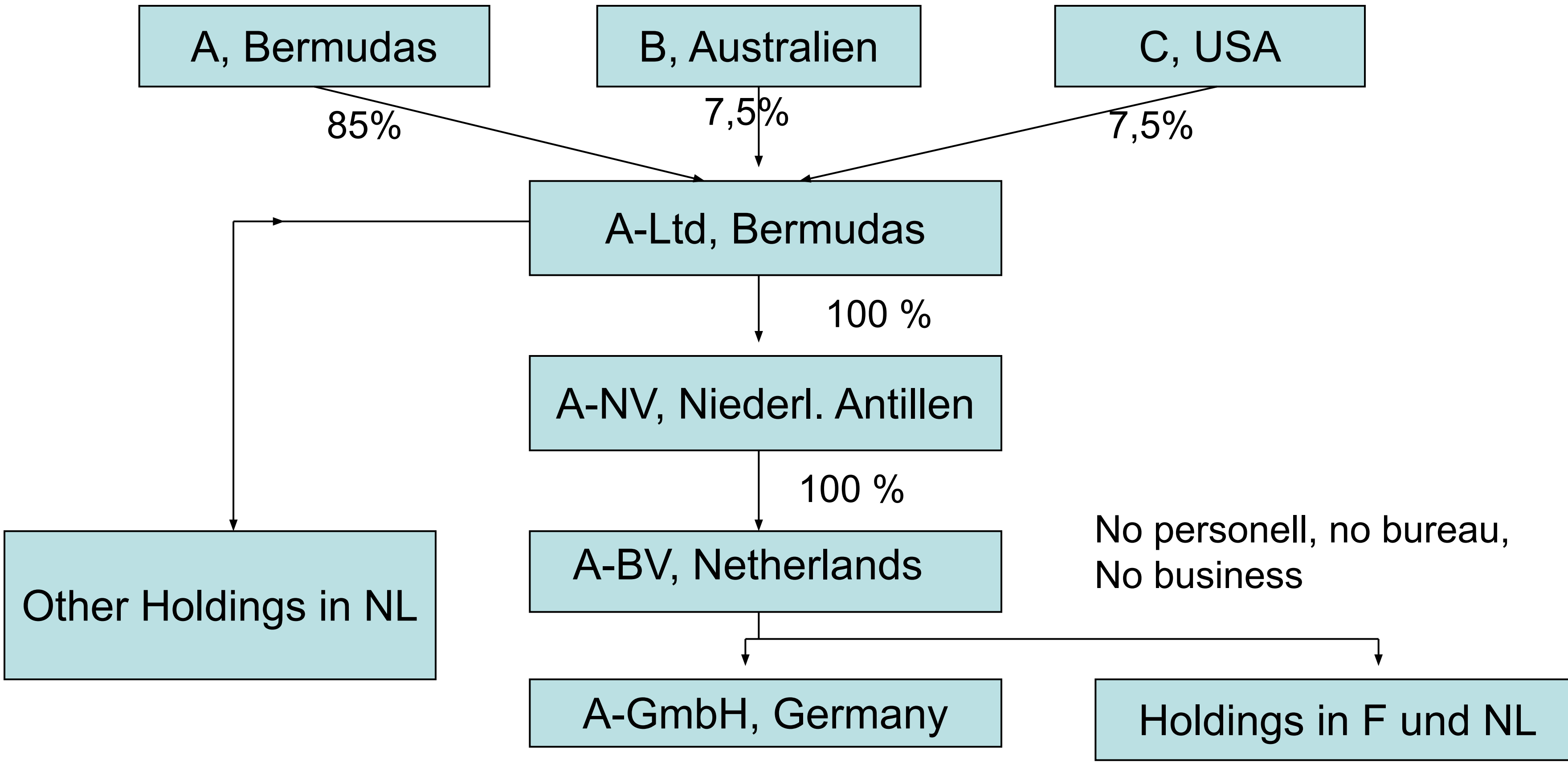
Double Taxation

Treaty shopping

- Objective: Use of beneficial DTA: Corporation as intermediate
- German law: § 50d III Income Tax Act. Preconditions:
  - The beneficial owner is not entitled to make use of the benefits of the Treaty if:
  - There are no sound economic reasons for the role of the corporation as intermediary
  - The corporation acting as intermediary has no own substantial (more than 10 % of income) and no sound business activities (“substance”

Treaty Shopping

Example for Treaty shopping



No personell, no bureau,
No business