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Internationales und EU-Steuerrecht

Teil II

Doppelbesteuerungsabkommen

(Foliensatz weitgehend übernommen von Univ.-Prof. DDr. Georg Kofler, LL.M.)

Dienstag, 9. 3.2010, 10:15 – 13:30 Uhr, MT 127

Mittwoch, 10. 3. 2010, 15:30 – 18:45 Uhr, MT 128

Dienstag, 16. 3.2010, 10:15 – 13:30 Uhr, MT 127

Mittwoch, 17. 3. 2010, 15:30 – 18:45 Uhr, MT 128

Overview

- **Structure and Terminology**
- **Five Rules of Treaty Application**
- **Methods for Elimination of Double Taxation**
- **Distributive Rules**
 - Business Profits and Permanent Establishments
 - Dividends, Interest and Royalties
 - Capital Gains
 - Employment Income
- **Special and Final Provisions**
- **Special Issues**
 - Beneficial Ownership and Abuse of Treaties
 - Conflicts of Qualification (“Partnership Report”)
 - Collective Investment Vehicles
 - Triangular Situations



Part I
Structure and Terminology

Source versus Residence

- **Taxing Jurisdiction**

- Nationality (citizenship of individuals, incorporation of companies)
- Territory
 - Persons – E.g., domicile, residence, place of management
 - Income – Source

- **Form of Taxation**

- **Residence** – “**Principle of Universality**” = Taxation of Worldwide Income (“Unlimited Tax Liability”)
- **Source** – “**Principle of Territoriality**” (“Limited Tax Liability”)
- Exercise of Taxing Rights – “Normal” Taxation (net base, regular progressive rate) versus Withholding Taxation (gross base, flat rate)
- Taxing Threshold – Existence of a permanent establishment, duration of stay (183 days) etc

Double Taxation

- **Elimination of Double Taxation**

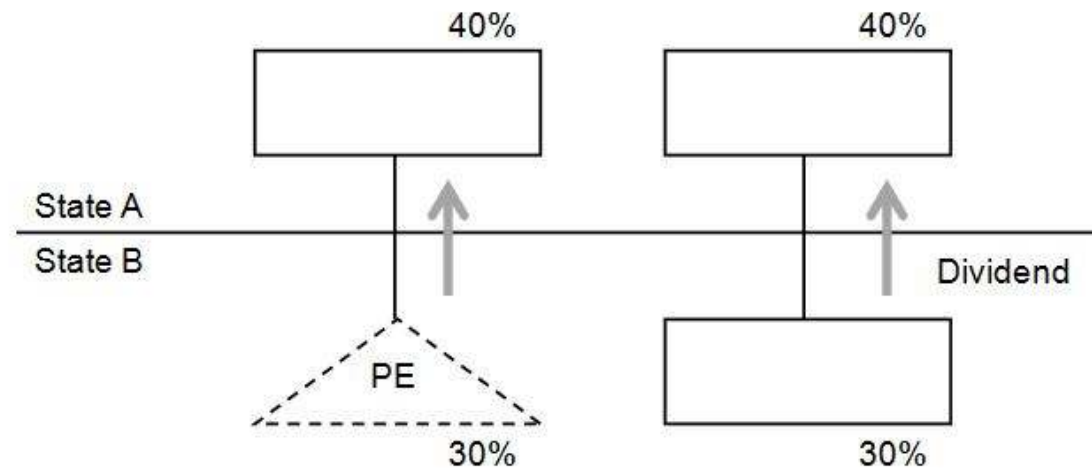
- Double Taxation Conventions (DTCs) = *Tax Treaties*
- Unilateral Measures

- **Forms of Double Taxation**

- Juridical (“Real”) Double Taxation
 - Unlimited tax liability in two countries – “Tie Breaker”-Rules in DTCs
 - *Unlimited tax liability in one country, limited tax liability in the other country* – Distributive Rules and Methods in DTCs
 - Limited tax liability in two countries → *Triangular Situations*
- Economic Double Taxation – E.g., Transfer Pricing and Art 9 OECD-MC

Subsidiary versus PE

– Subsidiary versus Permanent Establishment



Income in State B	100	100
./. Tax in State B	-30	-30
= After-Tax Income in State B	70	70
Dividend	-	70
./. Tax on Dividend in State B (e.g., 25%)	-	17,5
= Distributed Income	-	52,5
./. Tax in State A (40% on 100/70)	40	28
= After-Tax Income	30	24,5

Elimination of Double Taxation

- **Elimination of Double Taxation**
 - Distributive Rules
 - Credit of Exemption Method
- **“CEN” versus “CIN”**
 - **Capital Export Neutrality (CEN)**
 - Neutrality on the *Home* Market (eg, USA, UK)
 - Credit Method
 - **Capital Import Neutrality (CIN)**
 - Neutrality on the *Host* Market (eg, Austria, Germany)
 - Exemption Method
 - “Income Exemption”
 - “Tax Exemption” – Progressivity

Elimination of Double Taxation

– Credit Method versus Exemption Method

Double Taxation

Tax in Residence State

Worldwide Income → (200 in R + 100 in S =) 300 @ 40% → 120

Tax in Source State

Source Income → 100 @ 30% +30

Tax on Worldwide Income Without Relief = 150

Relief From Double Taxation

	Exemption	Credit
Tentative Tax in Residence State	120	120
Exemption of Source State Income	-40	-
Credit for Source State Tax	-	-30
Tax in Residence State	=80	=90
Tax in Source State	+30	+30
<i>Tax on Worldwide Income After Relief</i>	<i>=110</i>	<i>=120</i>

Elimination of Double Taxation

– Income Exemption versus Tax Exemption

Example 1

	<i>Income Exemption</i>	<i>Tax Exemption</i>
Worldwide Income (200 in R + 100 in S)	300	300
Income Exemption → 200 @ 40%	80	-
Tax Exemption →		
→ 300 @ 40%	-	120
→ Minus tax attributable to source		
State income: $(100/300) \times 120$	-	./ 40
<i>Tax in Residence State</i>	= 80	= 80

Example 2

	<i>Income Exemption</i>	<i>Tax Exemption</i>
Worldwide Income (200 in R + [-100] in S)	100	100
Income Exemption → 200 @ 40%	80	-
Tax Exemption →		
→ 100 @ 40%	-	40
→ Minus tax attributable to source		
State income	-	./ 0
<i>Tax in Residence State</i>	= 80	= 40

Objectives of Tax Treaties

**Eliminate Double Taxation and
Prevent Tax Avoidance and Evasion**



**Remove Tax Obstacles and Distortions to Cross-Border Trade
and Investment Flows**



**Maximize Global Wealth by Ensuring an
Efficient Allocation of Resources**

Objectives of Tax Treaties

– Main Objectives

- Eliminate the most common forms of *juridical and economic double taxation*
- Eliminate some forms of *tax discrimination*
- Provide a standardized set of rules for *dividing tax revenues* between countries
- Address *tax evasion and avoidance*
- Provide a framework for *settling tax disputes*
- Provide a *stable tax environment* to foreign investors
- And increase the *international competitiveness* of the economy

Operation of Tax Treaties

- **Restriction of Domestic Taxing Rights (“Stencil”)**
 - *Unlimited* Taxation in the *Source State* and Relief in the Residence State (e.g., immovable property)
 - *Limited* Taxation in the *Source State* and Relief in the Residence State (e.g., dividends, interest)
 - *Exclusive* Taxation in the *Residence State* (e.g., business income, pensions, other income)
 - *Exclusive* Taxation in the *Source State*
- **Relationship Between Domestic Law and Tax Treaty Law**
 - *Lex Posterior versus Lex Specialis*
 - “Treaty Override”
 - “Treaty Underride”

Legal Nature of Tax Treaties

- **There are currently around 3000 bilateral tax treaties**
 - These are part of the infrastructure of our global economy in the same way as the WTO agreements that regulate cross-border trade the bilateral investment agreements that regulate cross-border investment
- **Contract between Two States**
 - **Vienna Convention on the Law of Treaties** (Art 2)
 - International agreement (in one or more instruments, whatever called) **concluded between States** and **governed by International Law**
 - Only **creates rights and obligations for the States**, not third parties
 - In some countries tax treaties are also enacted as statutes → Once implemented, they create rights for taxpayers → “Treaty Underride”

OECD Model Tax Convention

- DTCs generally follow the structure of the **OECD Model Tax Conventions**, with variations to take account of national (e.g., **US Model Tax Convention**) and developing country requirements (e.g., **UN Model Tax Convention**)
- **OECD Model Convention**
 - **Chapter I.** – Scope Of Convention (Art 1 and 2)
 - **Chapter II.** – Definitions (Art 3 to 5)
 - **Chapter III.** – Taxation Of Income (Art 6 to 21)
 - **Chapter IV.** – Taxation Of Capital (Art 22)
 - **Chapter V.** – Methods Of Elimination Of Double Taxation (Art 23A and 23B)
 - **Chapter VI.** – Special Provisions (Art 24 to 29)
 - **Chapter VII.** – Final Provisions (Art 30 and 31)



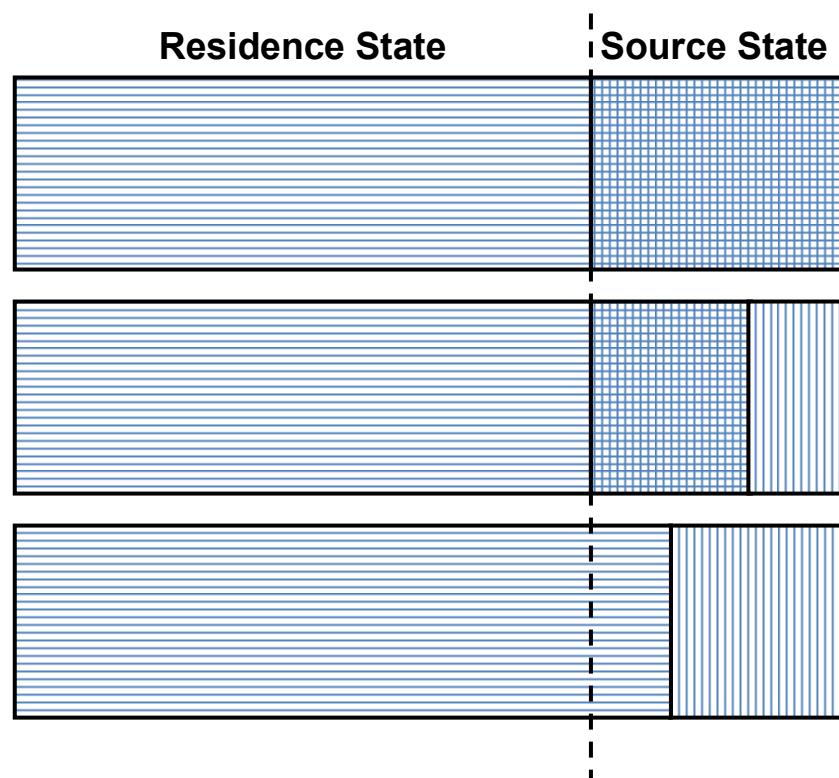
Part II
Five Rules of Treaty Application

Rules of Treaty Application

- **Rule 1**
 - ***Tax Treaties Restrict the Application of Domestic Tax Law (“Stencil”)***
- Rule 2
 - Tax Terms Can Have a Different Meaning in Domestic Tax Law and Treaty Law
- Rule 3
 - Correct Understanding of the Terms in Distributive Rules – Residence versus Source
- Rule 4
 - Correct Understanding of the Scope of Distributive Rules
- Rule 5
 - Issues Not Covered by Tax Treaties

Restriction of Domestic Tax Law

- Tax treaties *restrict the application of domestic tax law* in the residence state and in the source state



Full Taxation in Both States:

 = double taxation

Unilateral Relief in Residence State

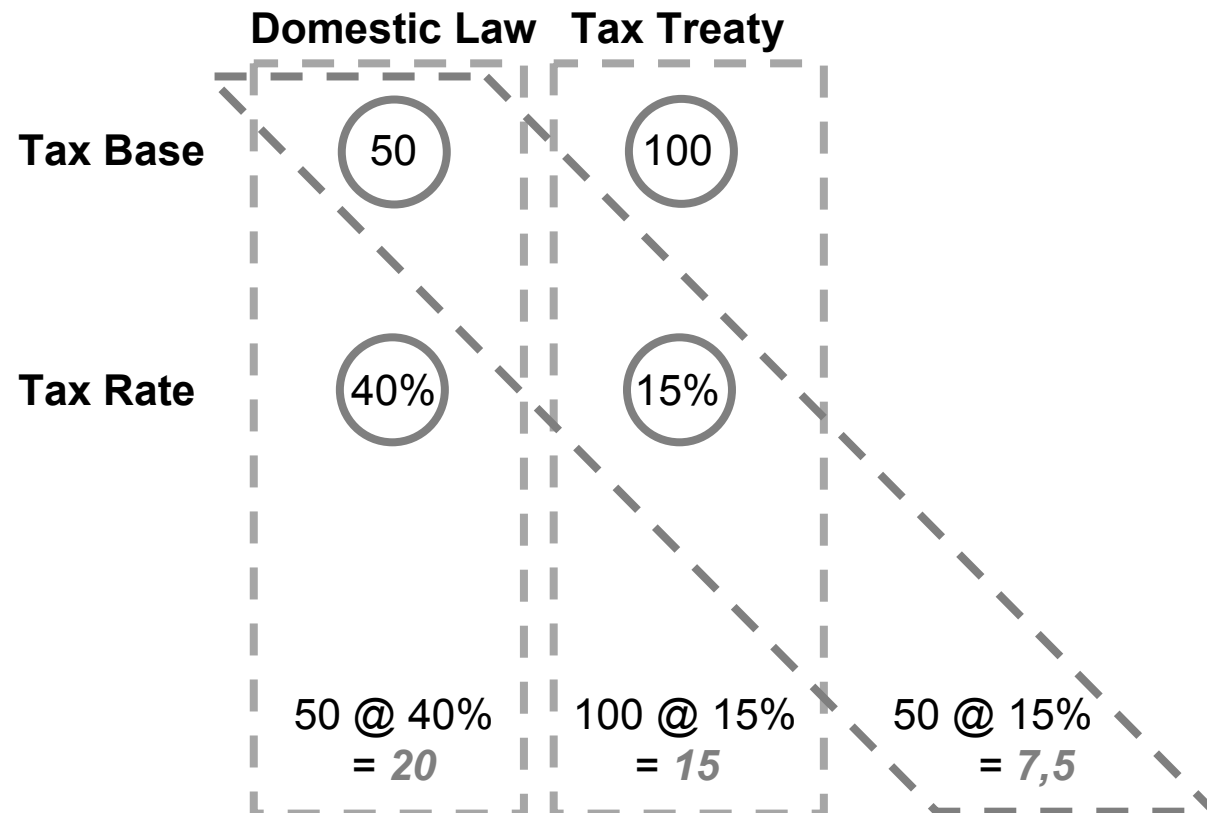
Application of DTC → Restriction of Source State Taxation and Relief in Residence State

Restriction of Domestic Tax Law

- **Distributive Rules – Articles 6-22 allocate taxing rights**
 - **Exclusive Taxation** – “... *shall be taxable only* ...” (generally in the residence State), e.g. Art 8.
 - **Concurrent taxation** – “... *may be taxed in* ...” (generally in the source State) - Two types:
 - Source tax with *no limits* (e.g. Art 7)
 - Source tax with *limits* (e.g. Art 11)
- **Double Tax Relief**
 - Art 23 provides *obligation to grant double tax relief* → “... *income which, in accordance with the provisions of the Convention, may be taxed in the other [State] ...*”.

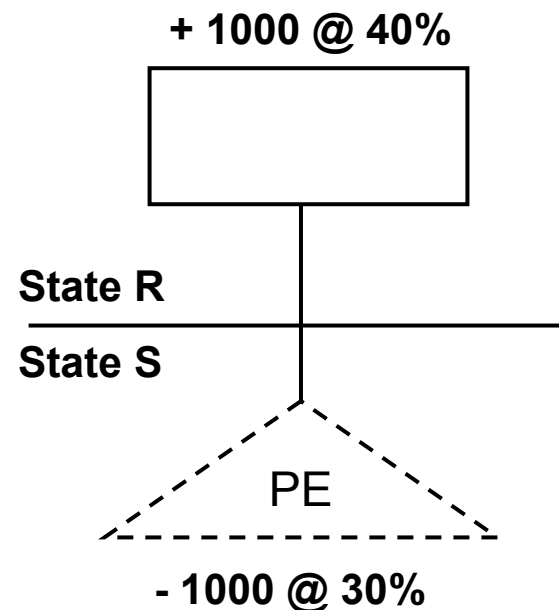
Restriction of Domestic Tax Law

- **Scope of Restriction – Interplay of Domestic Law and Tax Treaty Law**



Restriction of Domestic Tax Law

- **Tax treaties “restrict” domestic taxation**
 - The issue is therefore not whether a tax treaty “permits” taxation, but rather whether *it “prohibits” taxation*
 - Nevertheless, tax treaties *may result in a higher tax burden*



Rules of Treaty Application

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Interpretation

- **Vienna Convention on the Law of Treaties**
 - Signed May 23, 1969; entered into force January 27, 1980
 - Codification of customary international law
- **Art 26 – Pacta sunt servanda**
- **Art 31 – Interpretation**
 - “(1) A treaty shall be interpreted in *good faith* in accordance with the *ordinary meaning* to be given to the terms of the treaty in their *context* and in the light of its *object and purpose*.”
 - *Ordinary meaning of terms, subject to Art 31(4) special meaning and subject to Art 3(2) OECD Model*
 - *Context (text, contemporaneous agreements, subsequent agreements)*
 - *Purpose (part of context)*
 - (2) The context for the purpose of the interpretation of a treaty shall comprise in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.”

Interpretation

– Art 31 – Interpretation

- (3) There shall be taken into account, together with the context:
 - (a) any **subsequent agreement** between the Parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent **practice in the application** of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) any relevant rules of international law applicable in the relations between the parties.
- (4) A **special meaning** shall be given to a term if it is established that the parties so intended.“

– Art 32 – Supplementary Means of Interpretation

- "Recourse may be had to supplementary means of interpretation, including the **preparatory work** of the treaty and the **circumstances** of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:
 - (a) leaves the meaning ambiguous or obscure; or
 - (b) leads to a result which is manifestly absurd or unreasonable“
- *Includes travaux préparatoires and circumstances of conclusion of treaty*
- *Should include any relevant material, but unilateral, unpublished, or subsequent material should have less weight*

Interpretation

- **OECD Model Commentary**
 - **Theory** – Use of the OECD Commentary as a Tool for Treaty Interpretation?
 - *Ordinary meaning under Art 31(1) VCLT?*
 - *Part of the context of the treaty under Art 31(1) VCLT?*
 - *Instrument related to the treaty under Art 31(2)(b) VCLT?*
 - *Special meaning under Art 31(4) VCLT?*
 - *Supplementary means of interpretation under Art 32 VCLT?*
 - **Practice** – Courts, negotiators, competent authorities and practitioners use the OECD Model Commentary

Interpretation

- **Relevant Version of the OECD Model Commentary?**
 - Current version?
 - Intro Paras 3, 33-35 OECD Comm → “... tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention ...”.
 - Version available when the tax treaty was concluded?
 - Canada → *Specialty Manufacturing Ltd. v. Her Majesty the Queen*, 97 D.T.C. 1511 (1999); *MIL (Investments) S.A. (Appellant) v. Her Majesty the Queen*, 2006 DTC 3307
 - Netherlands → Hoge Raad der Nederlanden, 11 October 1978, BNB 1978/300, and 2 September 1992, BNB 1992/379
 - UK → *Fothergill v. Monarch Airlines* [1981] AC 251 (HL)
 - US → *National Westminster Bank v. U.S.*, 44 Fed. Cl. 120 (1999)
 - *But*: Later versions may have “persuasive force” → *Prévost Car Inc. v. The Queen*, 2009 DTC 5053, *IRC v. Commerzbank AG* [1990] STC 285 (Ch); *Trevor Smallwood Trust v. Revenue & Customs* [2008] UKSPC SPC00669

Interpretation

- **Relevant Version of the OECD Model Commentary?**
 - Differentiate between Commentaries
 - ... *that fill a gap in the existing commentary by covering matters not previously mentioned;*
 - ... *those that amplify the existing commentary by adding new examples or arguments to what is already there;*
 - ... *those that record what states have been doing in practice; and*
 - ... *those that contradict the existing commentary.*

Interpretation

- **Art 3(2) – Domestic Law Meaning for Undefined Treaty Terms**
 - “As regards the application of the Convention **at any time** by a Contracting State, any term not defined therein shall, **unless the context otherwise requires**, have the meaning that it has **at that time** under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.”
 - *What are undefined terms?*
 - *What if there are multiple domestic meanings?*
 - *Undefined terms used in treaty definitions?*
 - *When does a state apply the treaty?*
 - *What does “context” mean?*

Interpretation

- **Domestic Law Meaning under Art 3(2) – Timing Issues**
 - At the time the treaty was concluded?
 - At the time the treaty is applied?
 - Since 1995: “... *at that time* ...”
 - Art 3 Para 11 OECD Comm → “However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the *legislation in force when the Convention was signed* or *that in force when the Convention is being applied*, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the *latter interpretation* should prevail, and in 1995 amended the Model to make this point explicitly.”

Rules of Treaty Application

- Rule 1
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 - ***Correct Understanding of the Terms in Distributive Rules – Residence versus Source***
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Residence and Source

– Residence versus Source

- **Main Principle** – DTC applies only *to residents of contracting states* (Art 1) and **definition of “resident of a Contracting State” in Art 4**
- **Residence under Art 4 OECD-MC**
 - **Para 1** – “Resident of a contracting state” is defined as a “person” (individual or company) who is *liable to comprehensive taxation* in the state on the basis of certain criteria
 - *Provides a definition of “resident of a contracting state” for the purposes of applying other provisions of the DTC (e.g., Art 1)*
 - *“Full tax liability” – Based on the taxpayers’ personal attachment to the State concerned*
 - *Existence of a “permanent establishment” does not result in residency status (Crown Forest Industries Ltd. v. Canada, [1995] 2 S.C.R. 802)*
 - **Para 2** – Tie-Breaker Rule for Individuals
 - **Para 3** – Tie-Breaker Rule for Other Persons
 - *Provides solutions for cases where a person is considered as a resident of both treaty countries (“tie-breaker” rules for “dual residents”)*

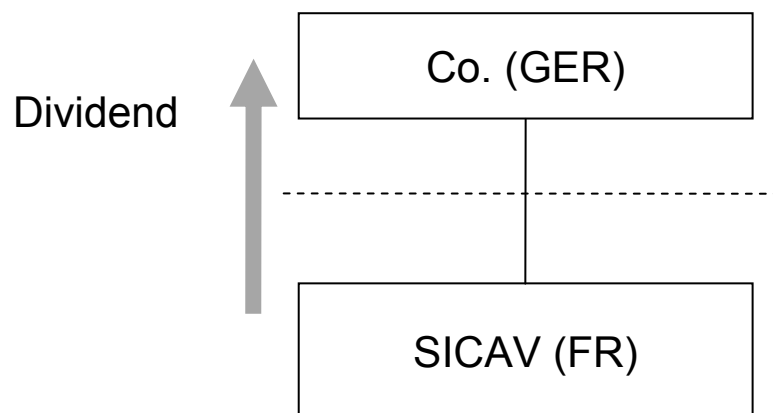
Residence and Source

– **Residence under Art 4(1) OECD-MC**

- “For the purposes of this Convention, the term “resident of a Contracting State” means any person who, *under the laws of that State*, is liable to tax therein by reason of his *domicile, residence, place of management or any other criterion of a similar nature*, and also includes that State and any political subdivision or local authority thereof.”
 - *Based on domestic law – Person is resident of a country if liable to tax in the country by reason of his domicile, residence, place of management or similar criterion*
 - *Exemption under domestic law, e.g. for pension funds, charities and other organisations*
- “This term, however, does not include any person who is liable to tax in that State *in respect only of income from sources* in that State or capital situated therein.”
 - *Foreign diplomatic and consular staff serving in a State’s territory*
 - *Not meant to cover countries adopting a territorial principle in their taxation (Art 4 Para 8.3 OECD Comm)*
 - *Relevance for Dual Resident Companies? → Art 4 Para 8.2 OECD Comm*

Residence and Source

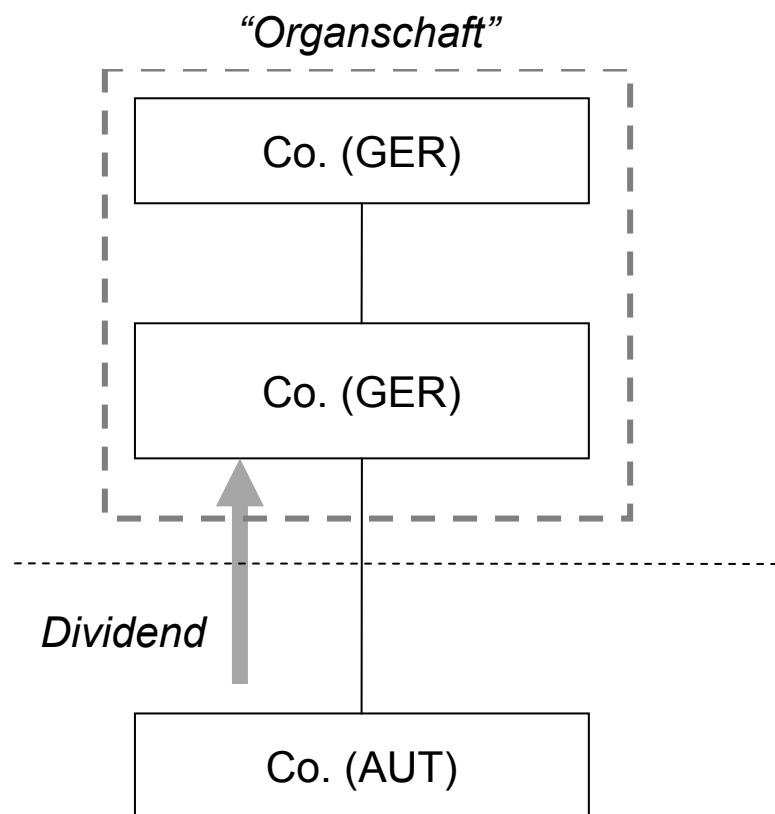
- **Art 4(1) OECD-MC – “Residency” of Corporations**
 - Fiscal Court Niedersachsen, 29 March 2007, 6 K 514/03



- Under FR-GER treaty, GER exempts dividends paid by a company resident in FR to a company resident in GER (10% minimum holding)
- SICAV is exempt and hence not subject to tax and no “resident” for treaty purposes, irrespective of how the entity would have been treated in GER, hence no exemption of dividends

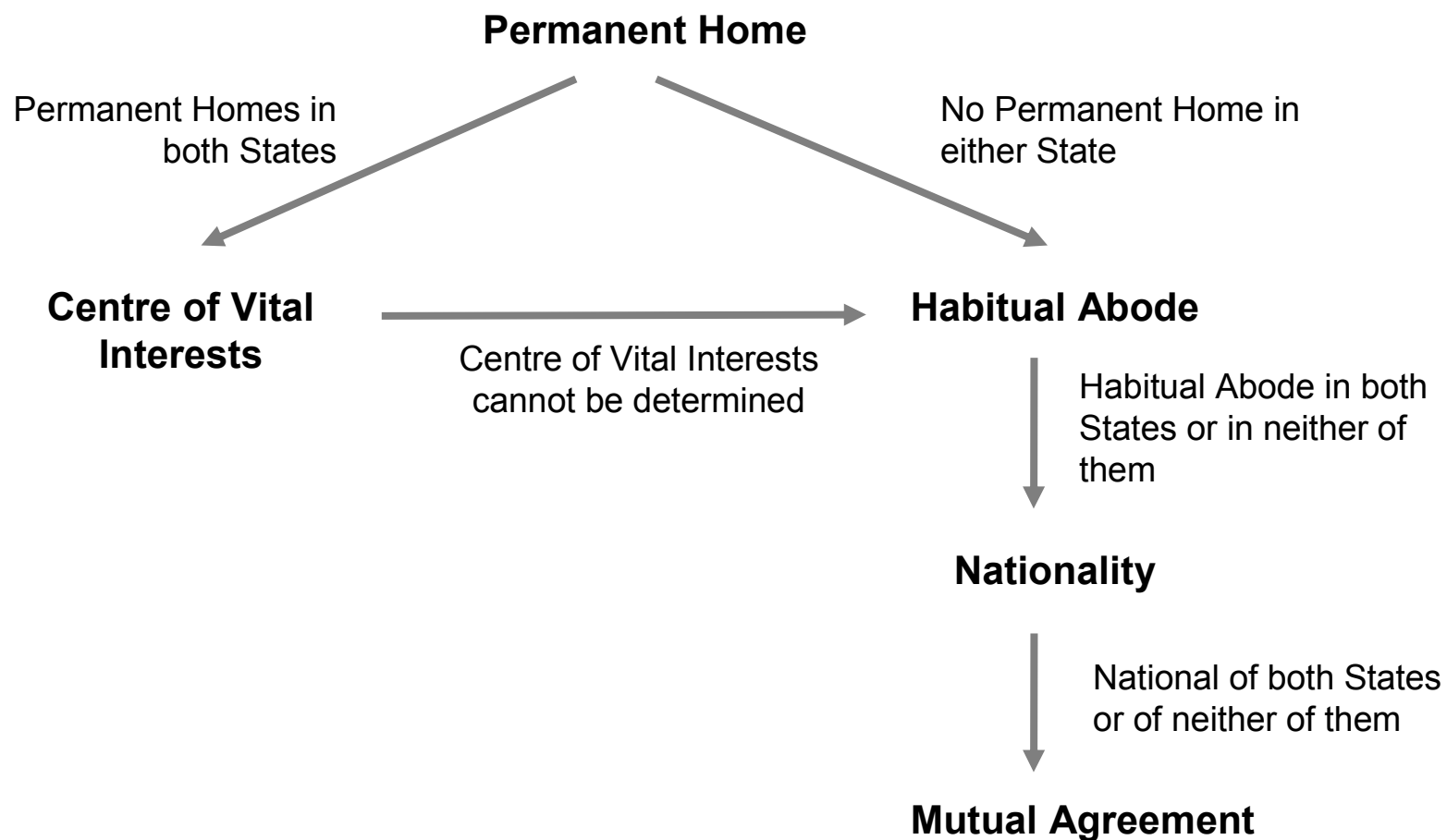
Residence and Source

- **Art 4(1) OECD-MC – “Residency” of Corporations**
 - Austrian Treaty Practice (EAS 1075, EAS 2415; aligned with Germany and Switzerland)
 - Isolated treatment of each group company, i.e., group taxation regimes leave treaty residence and entitlement to treaty benefits unaffected
 - Members of a foreign group will be entitled to claim treaty benefits, including a withholding tax reduction, even though income is attributed “away” from them



Residence and Source

– Tie Breaker Rule for Dual Resident Individuals (Art 4(2) OECD-MC)



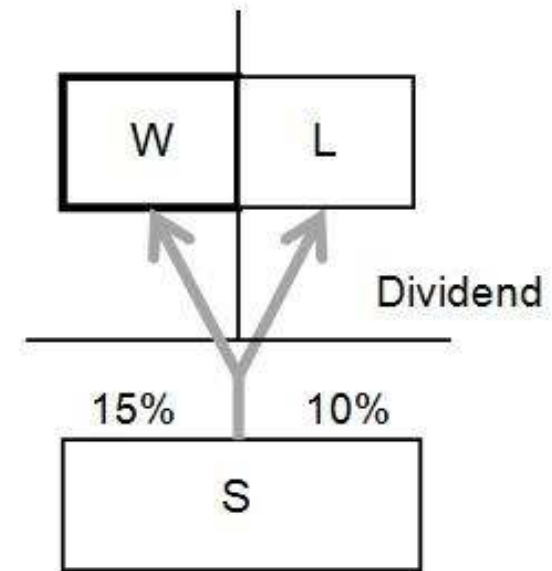
Residence and Source

- **Tie Breaker Rule for Dual Resident Companies**
 - **Art 4(3) OECD-MC** → “Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its *place of effective management* is situated.”
 - *OECD and UN Models adopt **Place of Effective Management** as Tie Breaker*
 - *Where the key management and commercial decisions are in substance made, where the actions to be taken by the entity as a whole are taken – Facts and circumstances!*
 - *Common alternatives → **Place of incorporation** or **Mutual Agreement Procedure** (“MAP”)*
 - **2008 OECD Alternative** (Art 4 Para 24.1 OECD Comm)
 - ***MAP** – No treaty benefits until a solution is found!*
 - ***Suggested Criteria** → Board of directors, where CEO and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person’s headquarters are located, which country’s laws govern the legal status of the person, where its accounting records are kept, improper use of the Convention*

Residence and Source

– Tie Breaker Rule for Dual Resident Companies

- Art 4(3) OECD-MC → “Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident ***only of the State in which its place of effective management*** is situated.”
- Art 4(1) ***second sentence*** OECD-MC → “This term, however, does not include any person who is liable to tax in that State ***in respect only of income from sources*** in that State or capital situated therein.”
 - Art 4 Para 8.2 OECD Comm (2008)
 - Art 4(1) ***second sentence*** “also excludes companies [...] who are not subject to comprehensive liability to tax in a Contracting State ***because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States.***”



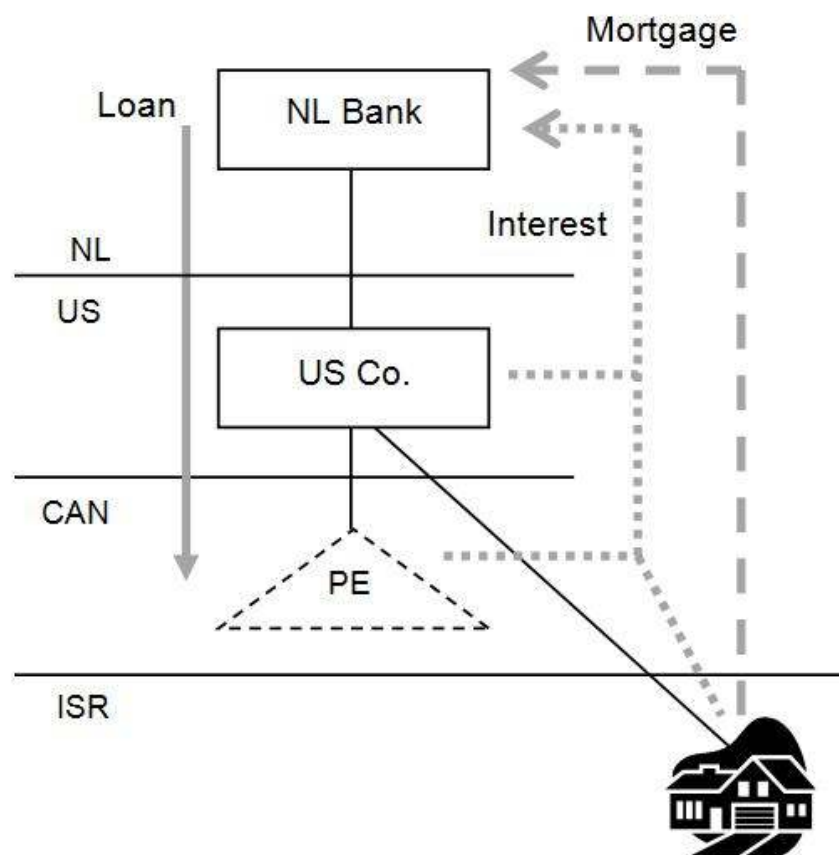
Residence and Source

– “The Other State” – Source State

- **Art 1 OECD-MC** → “This Convention shall apply to *persons who are residents* of one or both of the Contracting States.” → Refers to the *Recipient of the Income*, not to the “Payor” (= Source)!
- **“Sources”** are defined in the DTC – E.g.,
 - *Art 6(1) OECD-MC: “Income derived by a resident of a Contracting State from immovable property [...] situated in the other Contracting State may be taxed in that other State.” → Relevant is the **situs of the property**, not the residence of, e.g., the lessee. .*
 - *Art 11(1) OECD-MC (“Interest arising in a Contracting State”) → Art 11(5) OECD-MC: “Interest shall be deemed to arise in a Contracting State when the **payer is a resident** of that State.”*

Residence and Source

- **“The Other State” – Source State**
- Different source rules in different tax treaties
- Example: A Dutch bank gives a loan to US Co. for use in its Canadian permanent establishment and enters a mortgage on Israeli real property as a collateral



NL-US DTC → Payor
NL-CAN DTC → PE
NL-ISR DTC → Real Property

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 - Correct Understanding of the Terms in Distributive Rules – Residence versus Source
- **Rule 4**
 - ***Correct Understanding of the Scope of Distributive Rules***
 - ***Territorial Scope***
 - ***Substantive Scope***
 - ***Scope of Legal Ramifications***
- Rule 5
 - Issues Not Covered by Tax Treaties

Scope of Distributive Rules

– Territorial Scope

– **Bilateral** Scope

- *Art 6 – Immovable Property*
- *Art 10 – Dividends*
- *Art 11 – Interest*
- *Art 12 – Royalties*
- *Art 16 – Directors' fees*
- *Art 17 – Artistes and Sportsmen*

E.g., “Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State ...” (Art 10),
“Interest arising in a Contracting State and paid to a resident of the other Contracting State ...” (Art 11)

– **Worldwide** Scope

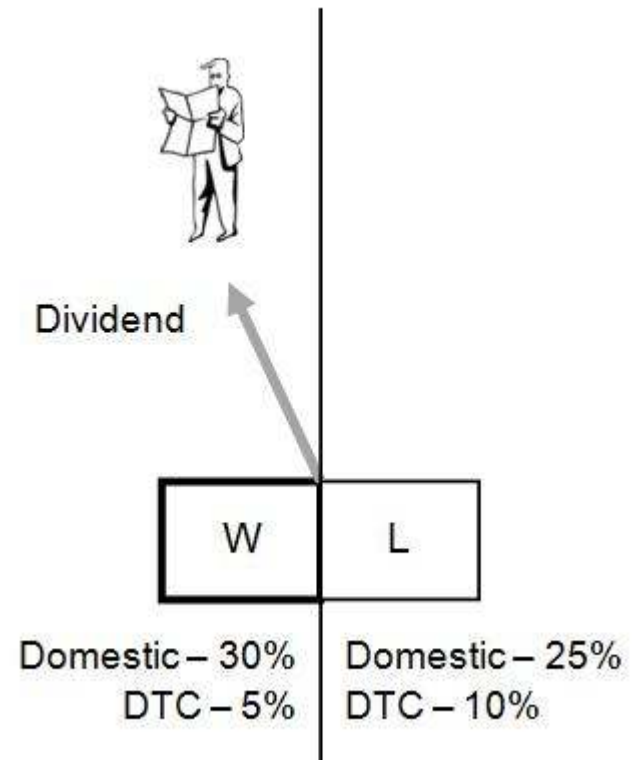
- *Art 7 – Business Profits*
- *Art 13 – Capital Gains*
- *Art 15 – Income from Employment*
- *Art 18 – Pensions*
- *Art 21 – Other Income*

E.g., “The profits of an enterprise of a Contracting State shall be taxable only in that State ...” (Art 7), “Items of income of a resident of a Contracting State, wherever arising, [...] shall be taxable only in that State” (Art 21)

Scope of Distributive Rules

– Territorial Scope

- If items of income are in principle covered by a **distributive rule with bilateral scope** and are derived from sources
 - in a **third state** or
 - from the **recipient's residence state**,
- then such items of income are **not** covered by this distributive rule!
- Such items of income are covered by **Art 7** (for business profits) or by **Art 21** (for other income) → Exclusive taxing right for the taxpayer's residence state!



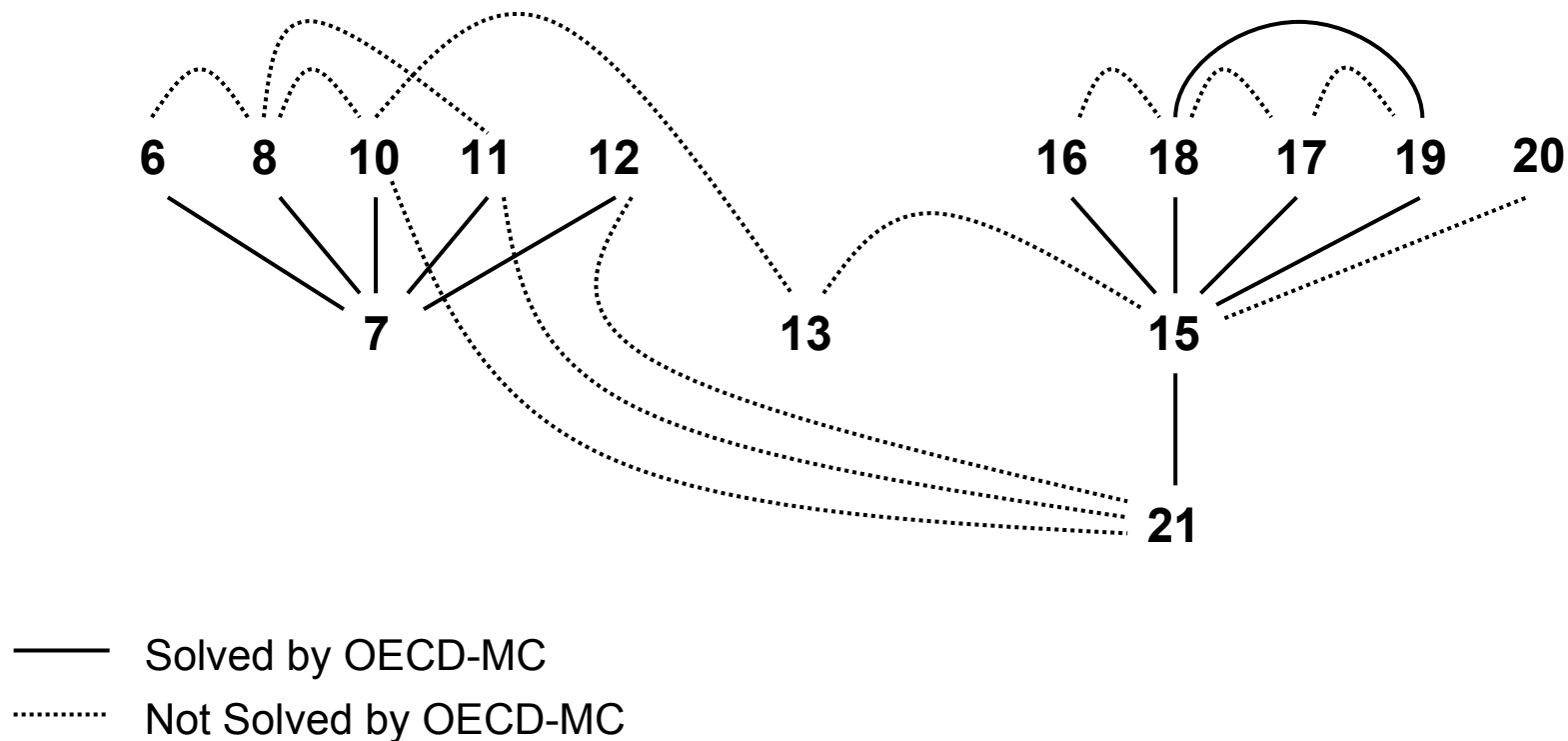
Scope of Distributive Rules

– **Substantive Scope**

- One Article is completely covered by the scope of another Article – *Lex specialis vs lex generalis*
 - *Examples: Art 7 vis-à-vis Art 8, Art 15 vis-à-vis Art 18*
 - *Generally solved by the DTC: Art 8 before Art 7 (Art 7(7)); Art 18 before Art 15 (Art 15(1))*
- Two Articles overlap without one being clearly narrower or wider in scope
 - *Examples: Art 6 vis-à-vis Art 7, Art 17 vis-à-vis Art 18*
 - *In some cases solved by the DTC: Art 6 before Art 7 (Art 6(4) and Art 7(7))*

Scope of Distributive Rules

– Substantive Scope



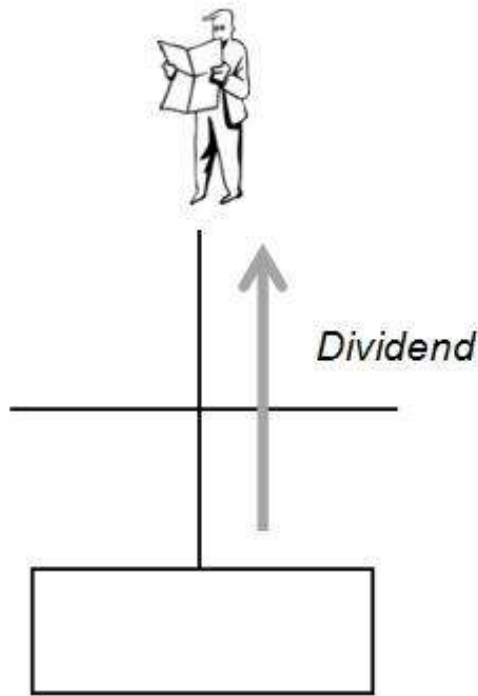
Scope of Distributive Rules

– Scope of Legal Ramifications

- “**Closed**” Distributive Rules → Exclusive Taxation
 - “... *shall be taxable only in that State* ...”
 - Exclusive Taxation usually in the **Residence** State → Art 7(1), Art 12(1), Art 13(5), Art 15(1) 1st sentence, Art 18, Art 19(1)(b) and (2)(b), Art 21(1)
 - Sometimes in the **Source** State: Art 8(1) and (2), Art 13(3), Art 19 (1)(a) and (2)(a) → Income **exempt** in the other State (but may be included to calculate progressive rate – Art 23A(3))
- “**Open**” Distributive Rules → Concurrent Taxation
 - “... *may be taxed* ...” – “... *may also be taxed* ...”
 - Source tax with **limits** → Art 10(2), Art 11(2)
 - Source tax with **no limits** → Art 7(1) 2nd part, Art 13(1), (2) and (2), Art 15(1) 2nd sentence and (3), Art 16, Art 17(1)
 - **Relief via Credit or Exemption in the Residence State (Art 23A or Art 23B)** → Art 23 provides an obligation to grant double tax relief (“... income which, in accordance with the provisions of the Convention, may be taxed in the other Contracting State ...”).

Scope of Distributive Rules

– Scope of Legal Ramifications



Article 10

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State **may be taxed** in that other State.
2. However, such dividends **may also be taxed** in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: [...]
b) **15 per cent** of the gross amount of the dividends in all other cases.

Article 23

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of **Articles 10** and 11, may be taxed in the other Contracting State, the first-mentioned State shall **allow as a deduction from the tax** on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

Scope of Distributive Rules

– Scope of Legal Ramifications — Overview

Article		Income	Rule	Residence State	Source State
6		Immovable Property	<i>ALSO</i>	Relief – Art 23	Situs
7	(1)	Business Profits	<i>ONLY</i>	Residence	—
	(2)	PE in the Source State	<i>ALSO</i>	Relief – Art 23	PE
8		Shipping, Air Transport	<i>ONLY</i>	POEM	—
10		Dividends	<i>ALSO</i>	Relief – Art 23	5%/10%
11		Interest	<i>ALSO</i>	Relief – Art 23	10%
12		Royalties	<i>ONLY</i>	Residence	—
13	(1)	Gains – Immovable Property	<i>ALSO</i>	Relief – Art 23	Situs
	(2)	Gains – Business Assets	<i>ALSO</i>	Relief – Art 23	PE
	(3)	Gains – Ships, Planes	<i>ONLY</i>	POEM	—
	(4)	Gains – Shares in Real Estate Companies	<i>ALSO</i>	Relief – Art 23	Situs of Real Estate
	(5)	Gains – All Other Property	<i>ONLY</i>	Residence	—

Scope of Distributive Rules

– Scope of Legal Ramifications — Overview

Article		Income	Rule	Residence State	Source State
15	(1)	Employment	<i>ALSO</i>	Relief – Art 23	Exercise
	(2)	< 183 days employment without sufficient nexus	<i>ONLY</i>	Residence	—
16		Director's Fees	<i>ALSO</i>	Residence	Residency of Company
17		Artistes and Sportsmen	<i>ALSO</i>	Relief – Art 23	Exercise (“look through”)
18		Pensions	<i>ONLY</i>	Residence	—
19	(1)(a)	Active Government Service	<i>ONLY</i>	—	Paying State
	(1)(b)	Active Government Service if Taxpayer is a Resident and National of Activity State	<i>ONLY</i>	Residence	—
	(2)(a)	Government Pensions	<i>ONLY</i>	—	Paying State
	(2)(b)	Government Pensions if Taxpayer is a Resident and National of the other State	<i>ONLY</i>	Residence	—

Scope of Distributive Rules

– Scope of Legal Ramifications — Overview

Article	Income	Rule	Residence State	Source State
20	Students	ONLY	Residence	<i>[Exception: Payments from Source State]</i>
21	Other Income	ONLY	Residence	—

Rules of Treaty Application

- Rule 1
 - Tax Treaties Restrict the Application of Domestic Tax Law (“Stencil”)
- Rule 2
 - Tax Terms Can Have a Different Meaning in Domestic Tax Law and Treaty Law
- Rule 3
 - Correct Understanding of the Terms in Distributive Rules – Residence versus Source
- Rule 4
 - Correct Understanding of the Scope of Distributive Rules
- **Rule 5**
 - ***Issues Not Covered by Tax Treaties***

Issues Not Covered

- **To obtain most of the benefits of a tax treaty**
 - Taxpayer must be a **resident** of a Contracting State (Art 1 and 4), ...
 - ... the **tax** must be covered by the convention (Art 2) and ...
 - ... is **not excluded** by specific provisions (e.g., a Limitation-of-Benefits-Clause)
- **But: Tax treaties generally do not determine *who* the taxable subject is**
 - “derived” – Art 6(1), Art 13, Art 14, Art 15, Art 16 and Art 17
 - “paid” – Art 10, Art 11, Art 12, Art 18, Art 19
 - “receives” – Art 20
 - “profits of an enterprise” or “income of a resident” – Art 7, Art 21
- **Consequences**
 - Domestic rules on the **attribution of income**
 - Domestic **anti-abuse rules** (e.g., GAARs, CFC, etc)
 - → *Beneficial Ownership and Abuse of Treaties*



Part III
Methods for Elimination of Double Taxation

Overview

- **Article 23A – Exemption Method**
 - “Exemption with Progression” for “**Active Income**” (Art 23A(1) and (3))
 - *Treatment of Losses (Art 23 Para 44 OECD Comm)*
 - *Treatment of “Personal” Deductions (Art 23 Para 39 – 43 OECD Comm)*
 - “Credit” for “**Passive Income**” (Art 23A(2) → Art 10 and 11, in practice also Art 12)
 - Avoidance of Double-Non-Taxation (Art 23A(4)) → ***Conflicts of Qualification***
- **Article 23B – Credit Method**
 - “Ordinary Credit Method” and Credit Limitation (Art 23B(1))
 - *“Tax Sparing” → Report “Tax Sparing a Reconsideration” (1998) and Art 23 Para 72 – 78.1 OECD Comm)*
 - “Progressivity” (Art 23B(2))
- **Principles applying to both articles**
 - Provides relief from double taxation where distributive rules allow taxation by source and residence State
 - Addressed to State of residence only, no regulation of source taxation.

Exemption Method - Art 23A OECD-MC

Art 23A (1) OECD-MC

„Where a resident of a Contracting State [R] derives income [...] which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State [S], the first-mentioned State [R] shall, subject to the provisions of paragraphs 2 and 3, exempt such income [...] from tax.“

Art 23A (3) OECD-MC

„Where in accordance with any provision of the Convention income is derived [...] by a resident of a Contracting State [R] is exempt from tax in that State, such State [R] may nevertheless, in calculating the amount of tax on the remaining income [...] of such resident, take into account the exempted income [...].“

– Full Exemption:

- Taxation in State R is limited to that part of the total income which it has the right to tax under the distributive rules.
- The tax is calculated applying the applicable tax rate for that portion of the total income, i.e. the foreign part is disregarded completely for domestic tax.

– “Exemption with Progression”:

- Taxation is limited to the portion of total income which the distributive rules allow, but at the tax rate applicable to the total income
- **Negative Progression:** Applying a lower tax rate as a consequence of losses from foreign sources → may result in zero-taxation where the total income is lower than the tax free amount in State R
- OECD leaves choice of method to Member States.

Exemption Method - Art 23A OECD-MC

– Treatment of Losses

- Income exemption → “symmetric” treatment of profits and losses
- Tax exemption → “asymmetric” treatment of profits and losses
- OECD does not favor either method

Example	Income Exemption	Tax Exemption
Worldwide Income (200 in R + [-100] in S)	100	100
Income Exemption		
→ Tax: 200 @ 40%	80	-
Tax Exemption		
→ Tax: 100 @ 40%	-	40
→ Minus tax attributable to source		
State income	-	./ 0
<i>Tax in Residence State</i>	<i>= 80</i>	<i>= 40</i>

- Income Exemption combined with negative progression takes source losses into account at least partially
- Tax Exemption requires “recapture” of losses in subsequent years to avoid a “**double dip**” of losses (cf. § 2 Abs 8 Z 3 EStG).

Exemption Method - Art 23A OECD-MC

– Treatment of “Personal” Deductions

- Splitting or full deduction of personal deductions?
- **Splitting and progressive tax rate** (cf. § 33 (10) EStG before AbgSiG 2007) → deduction in calculating the average tax rate before applying it to the taxable (domestic) income → the portion of the deductible amount attributable to foreign income is lost
- **Full deduction**: disregard personal deductions in calculating average tax and deduct after applying tax rate to domestic income (required by EC Freedoms!)

Example (cf. Art 23 Para 41 OECD Comm)

Foreign Income	100
Domestic Income	<u>100</u>
Total Income	<u>200</u>
Special expenditure	<u>-20</u>
Net Income	<u>180</u>
Personal allowance	-30
Income subject to tax	<u>150</u>

Amount to be exempt? 100? 90? 75? Other?

OECD leaves choice to Member States.

Exemption Method - Art 23A OECD-MC

Art 23A (2) OECD-MC

*„Where a resident of a Contracting State [R] derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State [S], the first mentioned State [R] **shall allow as a deduction from tax** on the income of that resident an amount equal to the tax paid in that other State [S]. Such deduction **shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State [S].**“*

Art 23A (4) OECD-MC

„The provisions of paragraph 1 shall not apply to income derived [...] by a resident of a Contracting State [R] where the other Contracting State [S] applies the provisions of this Convention to exempt such income [...] from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

– “Credit” for “Passive Income”

- State of residence is free to tax or exempt foreign interest and dividends
- Has to give deduction (=credit) for underlying tax up to maximum amount
- Maximum deductible amount is the smaller of:
 - Amount of domestic tax on interest or dividend
 - Amount of tax actually paid in S

– Avoidance of Double-Non-Taxation → *Conflicts of Qualification*

Credit Method - Art 23B OECD-MC

Art 23B (1) OECD-MC

„Where a resident of a Contracting State [R] derives income [...] which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State [S], the first-mentioned State [R] shall allow:

a. As a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

b. [...]

*Such deduction [...] **shall not**, however, **exceed that part of the income tax [...]**, as computed before the deduction is given, which is **attributable [...]** to the income [...] **which may be taxed in that other State [S]**.*

– Article 23B – Credit Method

- Credit/deduction given for the amount of foreign tax, **if** taxed in accordance with the DTC.
- Limitation of Credit (**ordinary credit**)
 - Tax actually paid in S
 - Tax due on the income derived from S (“maximum deduction” – *Anrechnungshöchstbetrag*)
 - “Per Country limitation”
- **Sparing Credit**
 - Deduction for tax not actually paid in S, but deemed to be paid – maintaining the incentive to invest in countries that lower their withholding tax (e.g. Brasil: deemed withholding tax of 25% on dividends, interest and royalties).