Part IV Distributive Rules

Overview

- Article 5 The PE Concept
- Article 6 Income from immovable property
- Article 7 Business profits
- Article 8 Shipping, inland waterways transport and air transport
- ¬ Article 9 Associated enterprises → Transfer Pricing
- ¬ Article 10 − Dividends
- ¬ Article 11 Interest
- Article 12 Royalties
- Article 13 Capital gains
- Article 14 [Deleted]
- Article 15 Income from employment
- Article 16 Directors' fees
- Article 17 Artistes and sportsmen
- Article 18 Pensions
- Article 19 Government service
- Article 20 Students
- Article 21 Other income

- The "PE Concept"

- ¬ → The key test which determines the right to tax business profits in the source state → Art 5 OECD-MC
- Allocation of taxing rights for business profits (Art 7(1))
 - Business profits taxed exclusively in the State of residence of the enterprise unless there is a "permanent establishment" in the other State
 - If a permanent establishment exists, profits attributable to the permanent establishment taxable in the PE State

¬ The "PE Concept" in Art 5 OECD-MC – Overview

- ¬ Para 1 Primary Rule → "For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on."
- Para 2 Illustrative (not Exhaustive) List of PEs → Examples of typical fixed places of business (requirements of Art 5(1) must be met)
- ¬ Para 3 Construction/Installation Projects
- Para 4 Activities not PEs → E.g., preparatory or auxiliary character
- Para 5 Dependent Agents may be a PE
- Para 6 Independent Agents not a PE
- Para 7 Control of a Subsidiary not a PE of the Parent (and vice versa)

¬ The "PE Concept" – Art 5(1) – Primary Rule

- "For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on."
- Checklist
 - "... place of business ..."
 - Any premises, facilities or installation used for carrying on the business whether or not used exclusively for that purpose
 - ¬ Space is at its disposal → Immaterial whether owned, rented or at the disposal of the enterprise
 - "... fixed ..."
 - "Location Test"
 - "Duration Test"
 - "... carried on ..."
 - Any situation where business activities are carried on at a particular location at the disposal of the enterprise for that purpose
 - "... through which ..."
 - ¬ Art 5 Para 4.1 4.6 OECD Comm → Painter (✓), paving a road (✓), regular use of use a delivery dock at a customer's warehouse (×), office in the headquarters of another company (✓)

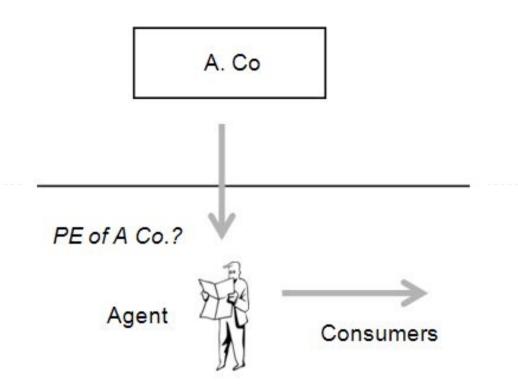
- ¬ The "PE Concept" Art 5(1) "Fixed"
 - A Specific Geographical Spot (the "Location Test") → Link between the place of business and a specific geographical point
 - Geographical fixedness has to be understood in the context of the business concerned
 - Mobile and Recurrent Activities → "Coherent Whole Commercially and Geographically"
 - Commercial Coherence → E.g., a single contract (plus connected contracts), complementary functions
 - Geographic Coherence → E.g., limited geographic area, distinct place (mine, offices of a client)
 - Another factor: A place regularly returned to, e.g., a street market
 - A Certain Degree of Permanence (the "Duration Test") → 6-Months-Test (Art 5 Para 6 OECD Comm)

- ¬ The "PE Concept" Art 5(3) Construction Activities
 - "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."
 - Building Site Construction (Renovation) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging
 - Installation Project Includes the installation of new equipment, such as a complex machine, in an existing building or outdoors
 - The Twelve-Month-Threshold
 - Applies to each individual site or project, but regarded as single unit if it forms a coherent whole commercially and geographically (even if based on several contracts)
 - From the date on which the contractor begins his work (including any preparatory work) until the work is completed or permanently abandoned (temporary or seasonal interruptions or discontinuations are included in determining the life of a site)

¬ The "PE Concept" – Art 5(4) – Activities Deemed Not to Be a PE

- Concept Remote from profit making and attribution of income would therefore be problematic and artificial
- The term "permanent establishment" shall be deemed not to include:
 - The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise (Art 5(4)(a))
 - The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery (Art 5(4)(b))
 - The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise (Art 5(4)(c))
 - The maintenance of a fixed place of business solely *for the purpose of purchasing* goods or merchandise or of collecting information, for the enterprise (Art 5(4)(d))
 - The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a *preparatory or auxiliary character* (Art 5(4)(e))
 - The maintenance of a fixed place of business solely for *any combination of activities mentioned in subparagraphs a) to e)*, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character (Art 5(4)(e))
 - Subpara (4)(f) added to the OECD.MC in 1977 and is now also in the UN Model
 → Concern that it permits too substantial a business presence without taxation

¬ The "PE Concept" – Art 5(5) and (6) – Agents



¬ The "PE Concept" – Art 5(5) – Dependent Agent

- "Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of an independent status to whom paragraph 6 applies is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise,"
 - No requirement for the dependent agent to have a fixed place of business But: Agent's place of business not necessarily a permanent establishment of the head office (Knights of Columbus v. Her Majesty The Queen, 2008TCC307, Tax Court of Canada, 16 May 2008)

¬ The "PE Concept" – Art 5(5) – Dependent Agent

- Criteria
 - "... habitually exercises ..." → To be understood in the context of the business concerned, nature of the contracts, presence should be more than merely transitory (Art 5 Para 33.1 OECD Comm)
 - ¬ "... an authority to conclude contracts ..." →
 - Negotiation of all details of the contract in a manner binding on the enterprise is sufficient (even if the contract is actually signed by someone else in the other contracting state (Art 5 Para 32.1 - 33 OECD Comm)
 - Not, e.g., in case of insurance approval by head office (90% approval rate) (*Knights of Columbus v. Her Majesty The Queen*, 2008TCC307, Tax Court of Canada, 16 May 2008)
 - "... in the name of the enterprise ..." → Not only when the contract is concluded literally in the name of the enterprise, but also where contract is binding on the principal (Art 5 Para 32 32.1 OECD Comm)

¬ The "PE Concept" – Art 5(6) – Independent Agent

"An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business."

- Criteria

- ¬ Legally Independent → The agent's commercial activities are not subject to detailed instructions or comprehensive control
- ¬ Economically Independent → Number of clients
- ¬ Acting in the Ordinary Course of his Business → Broker, commission agent

The "PE Concept" – Services PE

- Fees for technical services are not dealt with separately in neither the OECD nor UN Model Tax Convention
- Usually taxed under the Business Profits Article
 - Taxation in source state to the extent that there is a PE (Art 5) in the source state and the fees are attributable to it
 - UN-MC deems a PE to exist in respect of services performed for more than
 6 months in respect of a single or connected projects (Art 5(3)(b) UN-MC)
 - OECD Alternative Provision → Art 5 Para 42.11 42.48 OECD Comm

Immovable Property – Art 6 OECD-MC

Art 6 (1) OECD-MC

"Income derived by a resident of a Contracting State [R] from immovable property (including income from agriculture and forestry) situated in the other Contracting State [S] may be taxed in that other State [S]."

- Principle

- State of source has right to tax income from immovable property, no rule regarding State of residence ("open distributive rule")
- State of source = the State in which the property is situated
- Bilateral scope of application
- What does the term "immovable property" contain?
- What income is "derived from" immovable property?

Immovable Property – Art 6 OECD-MC

Art 6 (2) OECD-MC

"The term "immovable property" shall have the meaning which it has under the law of the Contracting State [S] in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircrafts shall not be regarded as immovable property."

Meaning of immovable property

- Derived from the law of the source
 State → binding definition for State
 R.
- Additional treaty "definition":
- property accessory to IP
- livestock and equipment of agriculture
- various rights connected to IP
- Excluded: ships, boats, aircraft.

Immovable Property – Art 6 OECD-MC

Art 6 (3) OECD-MC

"The provisions of paragraph 1 shall apply to income derived from the direct use, letting or **use in any form** of immovable property."

Art 6 (4) OECD-MC

"The provisions of paragraph 1 and 3 shall also apply to the income from immovable property of an enterprise."

Income derived from IP

- Income derived from the use of the immovable property in any form
- Renting, leasing, agricultural use of land, forestry, mining etc.
- Not included: capital gains on land
 → Art 13 Para 1 OECD-MC

Relationship to Art 7 OECD-MC

- Priority with regard to legal consequence: source State taxation regardless of existing PE!
- Income may nonetheless be qualified as "business income" within Art 7 OECD-MC → may thus create a PE

Principle

 Source country has a prior unlimited right to tax business profits earned by a nonresident to the extent that those profits are attributable to a PE situated in the source country

Art 7(1) OECD-MC
Only Residence State may
tax business profits unless
PE in the Source State

Art 5 OECD-MC
Definition of PE

Art 7(2) OECD-MC
Source State may only tax
profits attributable to PE

Head Office

Head Office

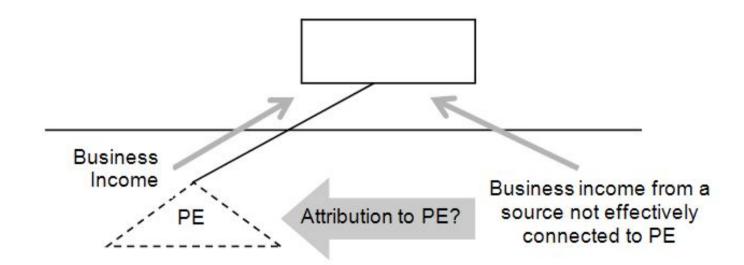
Structure of Art 7 OECD-MC

- Para 1 Residence country has exclusive right to tax business profits, unless there is a PE in the source country.
 - ¬ No force of attraction in OECD-MC, limited force of attraction in UN-MC.
- Para 2 Central directive for attribution of profits to PEs → "The Distinct and Separate Entity Principle" → AOA
- Para 3 Expenses wherever incurred for the purposes of the PE shall be deductible in computing the profits of that PE
- Para 4 Apportionment of total profits of an enterprise is allowed to attribute profits to a PE in source country provided it is customary (insurance/banking industry).
- Para 5 No profits shall be attributed to a PE by reason of the mere purchases of goods by the PE for the non-resident enterprise.
- Para 6 Unless there is a compelling reason for the contrary, the same method should be used each year for allocating profits to PEs.
- Para 7 Art 7 is lex generalis, other distributive rules take precedence, such as Art 10, 11 and 12

Art 7(1) OECD-MC – Overview

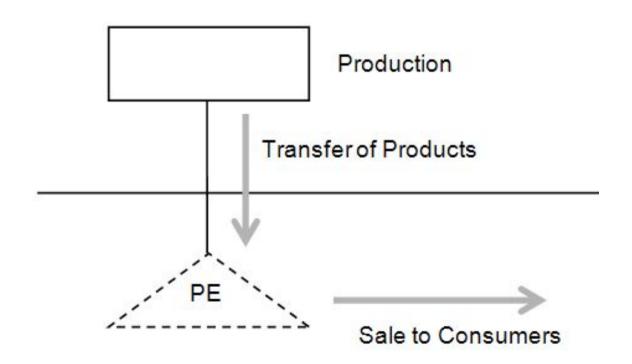
- The profits of an enterprise of a Contracting State shall be taxable *only in that*State unless the enterprise carries on business in the other Contracting State through a *permanent establishment* situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."
- Taxation in residence State only, unless there is a PE → If so, so much of the profits attributable to PE taxable in PE State
- Two Approaches
 - "Relevant Business Activity" Approach → "... so much of them ..."
 sometimes interpreted as limiting right to tax of PE State to overall
 enterprise profits → "As paragraph 2 is part of the context in which the
 sentence must be read, that sentence should not be interpreted in a way
 that could contradict paragraph 2, e.g. by interpreting it as restricting the
 amount of profits that can be attributed to a permanent establishment to the
 amount of profits of the enterprise as a whole." (Art 7 Para 11 OECD Comm)
 - ¬ "Functionally Separate Entity" Approach → Art 7(2) → "The Distinct and Separate Entity Principle" → AOA

- Art 7(1) OECD-MC "Force of Attraction"
 - ¬ OECD MC rejects force of attraction (Art 7 Para 10 Comm and AOA I/A Para 10)
 - ¬ UN MC contains limited force of attraction (Art 7(1)(b) and (c))
 - "Sales in that other State of goods or merchandise of the same or similar kind as those sold through that PE" or
 - "other business activities carried on in that other State of the same or similar kind as those effected through that PE"



- Art 7(2) OECD-MC - General Directive

Attribution to PE of "profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."



Art 7(2) OECD-MC

- Problem

- No consistent application of the attribution of profits under the terms of Art 7
 OECD-MTC
- Scope of the fiction of a separate enterprise and the autonomy of the PE
- ¬ Result → Double taxation or double non-taxation

Solution

- OECD Report on the attribution of profits to permanent establishments ("AOA")
- Objective: Finding one uniform method for the attribution of profits to PE
- "Working hypothesis": Application of the arm's length principle of Art 9 OECD-MC and the OECD Transfer Pricing Guidelines to the attribution of profits to PE

Art 7(2) OECD-MC – General Directive

- Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."
 - Profits that can be attributed to a permanent establishment are not limited to the amount of profits of the enterprise as a whole (Art 7 Para 11 OECD Comm)
 - ¬ Trading accounts of the PE are the starting point for profit allocation. If they are prepared symmetrically, they reflect real economic functions, and hey are in accordance with the arm's length principle → "These trading accounts could be accepted by tax authorities" (Art 7 Para 19 OECD Comm)
 - ¬ PE State may tax notional profits when an asset leaves the State, because concept of realization depends on domestic law. Residence State must seek a bilateral solution on a case by case basis (Art 7 Para 21 OECD Comm).

Art 7(3) OECD-MC – Cost Deduction

- "In determining the profits of a permanent establishment, there shall be allowed as *deductions expenses which are incurred for the purposes of the permanent establishment,* including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."
 - Clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in Art 7(2).
 - The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment (e.g., general administrative expenses; Art 7 Para 27 OECD Comm)
 - ¬ Prices between the permanent establishment and the head office → Arm's length or actual cost?

- Art 7(3) OECD-MC Cost Deduction
 - "Exceptions" to the Arm's Length Principle
 - Temporary transfer of assets (Art 7 Para 33 OECD Comm)
 - Intangibles (Art 7 Para 34 OECD Comm)
 - Services (Art 7 Para 35-37 OECD Comm)
 - Good management (Art 7 Para 38-40 Comm)
 - Transfer of funds (Art 7 Para 41-48 Comm)
 - UN-MC No deduction for internal royalties, fees, other similar payments, commissions, interest etc (Art 7(3) UN-MC)

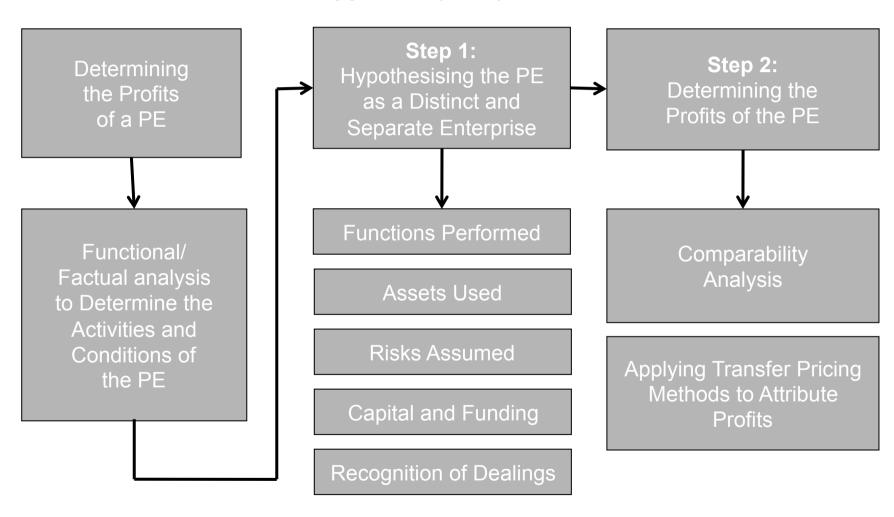
- 1994 Report on "Attribution of Income to Permanent Establishments" (Issues in International Taxation No. 5, OECD, Paris, 1994) and changes to the Commentary on Art 7
- 1995 "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations"
- 2008 Report on "Attribution of Profits to Permanent Establishments"
 - Part I General (2001 and revised 2004 and 2006)
 - Part II Banks (2003 and revised 2006)
 - Part III Global Trading (2003 and revised 2006)
 - Part IV Insurance (2005 and revised 2008)

- 2008 Revised Commentary on Art 7
 - Incorporation of AOA conclusions into the Commentary on existing Art 7 to the extent that they do not conflict with the existing commentary
 - Conflicts → E.g., allocation of economic ownership of certain assets (e.g. intangibles) and explicit recognition of internal dealings (internal services at arm's length prices, internal dealings in the form of licenses, internal dealings in the form of loans when there is a treasury function)
- 2010 New Article 7 and related Commentary
 - "Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention" (July 2008)

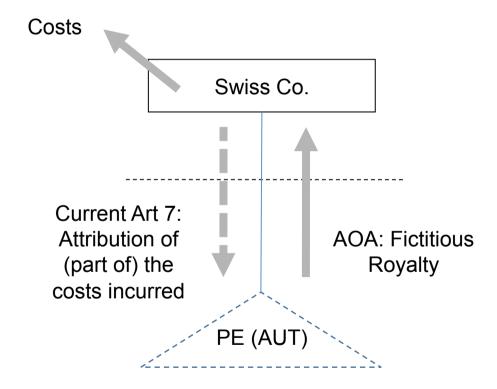
- ¬ Principle Decision of the OECD Member Countries to determine the PE's profits as if it were a distinct and separate enterprise → Arm's Length
 - ¬ Absence of legally binding contracts between head office and PE → Requirement for an approach to attribute risks, economic ownership of assets and capital to the PE.
 - Recourse to **functional analysis**, i.e. significant people functions (formerly: KERT function) as basis for hypothesising the PE as distinct and separate enterprise and determining the profits of the PE
- Justification Art 7(2): "... shall be attributed to that permanent establishment the profits which it might be expected to make if it where a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions...."
- Effect Attribution of profit generally possible even if enterprise as a whole makes a loss, and vice versa (Art 7 Para 11 OECD Comm)

- Two Step Approach
 - Step 1 "Hypothesising the PE as a Disctinct and Separate Enterprise" (AOA I/B-3 Paras 16-41 and AOA I/D-2 Paras 86-217)
 - Functional and Factual Analysis (AOA I/B-3 Paras 16-20)
 - Attribution of Assets (AOA I/B-3 Paras 21-23 and AOA D-2 Paras 101-128)
 - Attribution of Risks (AOA I/B-3 Paras 24-30 and AOA D-2 Paras 97-100)
 - Attribution of Free Capital (AOA I/B-3 Paras 31-35 and AOA D-2 Paras 130-183)
 - Recognition of Dealings (AOA I/B-3 Paras 36-41 and AOA D-2 Paras 207-217)
 - Step 2 "Determining the Profits of the Hyothesised Disctinct and Separate Enterprise Based Upon a Comparability Analysis" (AOA I/B-4 Paras 42-46 and AOA I/D-3 Paras 218-283)
 - Applying by analogy the transfer pricing methods in the OECD Transfer Pricing Guidelines (TPG)

The Authorised OECD Approach (AOA) – Overview



- Implementation of the Authorised OECD Approach (AOA) Existing Treaties
 - ¬ Areas where AOA conflicts with the existing Commentary → Royalties
 - Swiss Co. has a PE in Austria to produce cosmetic products. R&D has been done in Swiss Co.; patents, formulas etc are hence not economically owned by the Austrian PE.



Shipping etc – Art 8 OECD-MC

Principle

- Taxation of profits from international traffic (shipping, inland waterways and air): one state only!
- State where place of effective management is situated
- "Profits":
 - Profits directly obtained from transportation of passengers or cargo
 - Profits from activities directly connected to such operations as well as ancillary activities

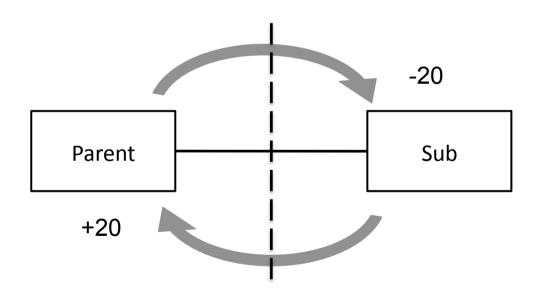
Where POEM is aboard a ship:

- taxation by harbour state
- Or state of residence of the operator

Associated Enterprises – Art 9 OECD-MC

¬ Principle:

- Deals with "adjustments of profits where transactions between associated enterprises other than arm's length"
- The problem: transactions between associated enterprises may be used to arbitrarily reduce profits in one state
- The solution: application of the "arm's length standard"



Transfer Pricing – Art 9 OECD-MC

Associated enterprises

- Participation in management, control or capital of one enterprise in the other
- Participation in management, control or capital of the same persons in two enterprises (of the contracting states)
- No determined threshold of participation

Commercial relation not at arm's length

 Conditions in the relations (dealings, transactions) which differ from those between independet enterprises

- Consequence:

- Adjustment of prices/profits (Art 9 para 1)
 - Profits may be included which would have otherwise accrued to the enterprise
- Corresponding adjustment (Art 9 para 2)
 - Adjustment in profits of the other enterprise (reduction of profits) by the other state ("appropriate adjustment")
- Secondary adjustment (no rule)
 - "Explain" difference in money flows in the books (loan; hidden profit distribution → constructed dividend, loan or equity contribution)

Transfer Pricing – Art 9 OECD-MC

- The "Arm's length principle":
 - Fundamental principle to delimit taxing rights between states
 - Find the "correct price" or "correct profit" as the main problem!
 - Transactional methods
 - Non-transactional methods
 - → OECD transfer pricing guidelines
 - Traditional Transactional methods
 - Comparable uncontrolled price (CUP)
 - Ideal, but almost never exists
 - Cost plus method (CPM, C+)
 - Start from costs and add comparable "mark-up"
 - Resale price minus (RPM)
 - Start from resale price and deduct costs and "mark-up"
 - Transactional profit methods
 - Transactional net margin method (TNMM)
 - Compare profit from similar transaction
 - Profit split method (PSM)
 - Divide total profit on each party

Transfer Pricing – Art 9 OECD-MC

Key features of transfer pricing in practice:

- Documentation
 - Burden of proof on enterprise
 - Documentation needed to prove value of reported prices
- Advance Price Agreements (APAs)
 - Bilateral
 - Unilateral

Criticism

- High documentary burden on enterprises
- Arm's length price does not exist in reality
- Arm's length does not reflect idea of corporate group

Alternative

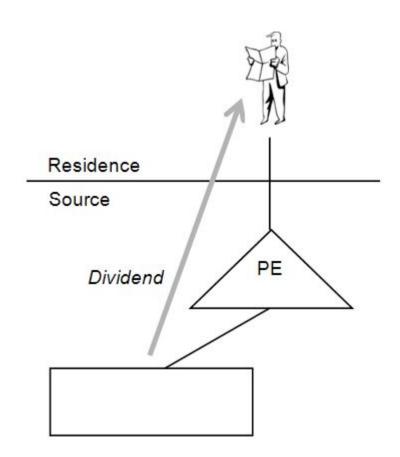
- (Global) Formulary Apportionment
 - Requires coordination of countries (multilateral agreement on apportionment of profits)

- ¬ "Dividends" → Distribution of profits to the shareholders by companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies → Legal entities with a separate juridical personality distinct from all their shareholders (≠ transparent partnerships)
- Structure of Art 10 OECD-MC
 - Para 1 Residence state may tax → "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."
 - Para 2 Maximum Source State Taxation Rate → "Beneficial Ownership" Requirement → Relief in the Residence State (Art 23A or Art 23B OECD-MC)
 - 5% → Corporate Shareholder with a Capital Holding of at least 25% → "Capital" under company law, but consideration of domestic tax law (e.g., "thin capitalisation", or assimilation of a loan to share capital; Art 10 Para 15 OECD Comm)
 - \neg 15% \rightarrow All other cases
 - No Minimum Holding Period in the OECD-MC, but Alternative Provision in Art 10 Para 17 OECD Comm → "... provided that this holding was not acquired primarily for the purpose of taking advantage of this provision".
 - Para 3 Definition of Dividends
 - Para 4 Art 10 does not apply to dividends from holdings connected with a permanent establishment in the source country → Art 7
 - Para 5 Extraterritorial Taxation

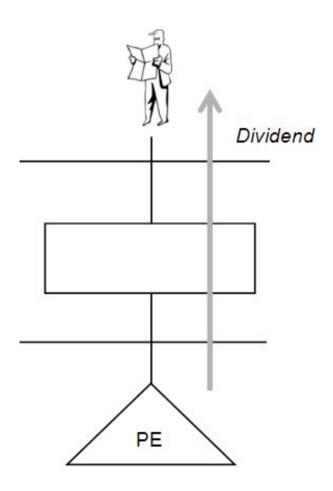
Art 10(3) OECD-MC – Definition of Dividends

- The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."
 - Not only "open" distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation and disguised distributions of profits (Art 10 Para 28 OECD Comm).
 - Also: Loans if the lender effectively shares the risks run by the company → E.g., repayment of the loan is subordinated to claims of other creditors or to the payment of dividends, the level or payment of interest would depend on the profits of the company, the loan contract contains no fixed provisions for repayment by a definite date (Art 10 Para 25 OECD Model Commentary).
 - Not included → E.g., debt-claims participating in profits (Art 11 Para 19 OECD Comm)

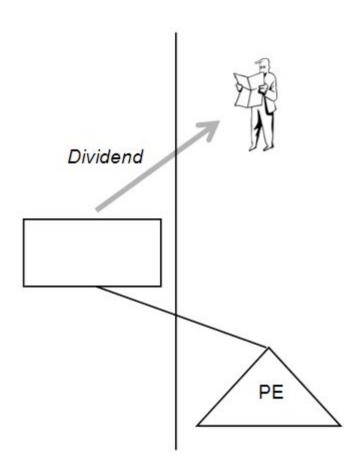
- Art 10(4) OECD-MC Dividends
 Connected with a PE
 - "The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."



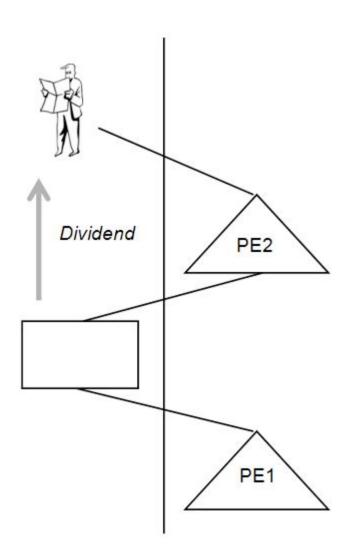
- Art 10(5) OECD-MC Extraterritorial
 Taxation Situation 1
 - "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State. that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State. nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State "



- Art 10(5) OECD-MC Extraterritorial Taxation - Situation 2
 - "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State. that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."
 - Shareholder's State may tax under Art 10(1) OECD-MC



- Art 10(5) OECD-MC Extraterritorial
 Taxation Situation 3
 - "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or *insofar* as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."
 - PE State may tax under Art 7 OECD-MC (Art 21(2) OECD-MC)



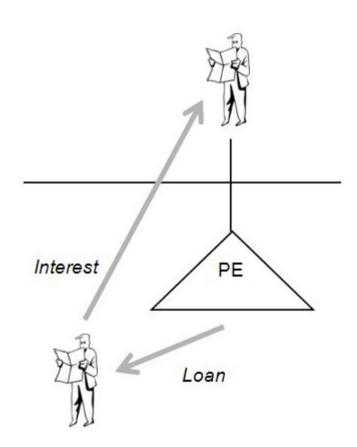
Structure of Art 11 OECD-MC

- Para 1 Residence state may tax → "Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State."
 - ¬ "... paid ..." → Fulfillment of the obligation
 - "... arising ..." → Art 11(5) OECD-MC
- Para 2 Maximum Source State Taxation Rate (10%) → "Beneficial Ownership"-Requirement → Relief in the Residence State (Art 23A or Art 23B OECD-MC)
- Para 3 Definition of Interest
- Para 4 Art 11 does not apply to interest from debt-claims connected to a permanent establishment in the source country → Art 7
- ¬ Para 5 Sourcing rule → Residence of the Payer, State of the PE
- Para 6 "Special Relationship Clause" → The restriction on the source country right to tax does not apply to the excess amount which has its basis in a "special relationship" ("Arm's Length")

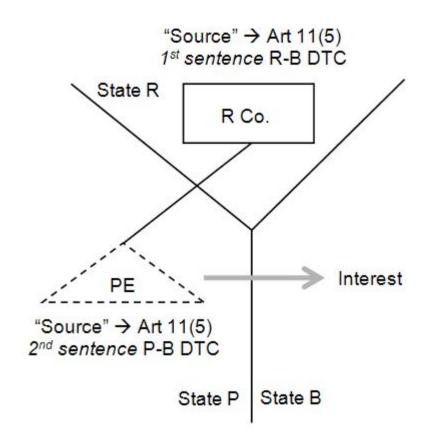
- Art 11(3) OECD-MC - Definition of Interest

- Income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits
 - E.g., cash deposits and security in the form of money, government securities, bonds and debentures (including premiums or prizes attaching thereto)
 - ¬ Not covered → Penalty charges for late payment
- Optional Exclusion from Source Taxation, e.g.,
 - Interest paid to a State, its political subdivisions and to central banks (Art 11 Para 7.4 OECD Comm)
 - Interest paid by a State or its political subdivisions (Art 11 Para 7.5 OECD Comm)
 - Interest paid pursuant to export financing programmes (Art 11 Para 7.6 OECD Comm)
 - Interest paid to financial institutions (Art 11 Para 7.7 OECD Comm)
 - Interest paid to some tax-exempt entities (e.g. pension funds) (Art 11 Para
 7.10 OECD Comm)

- Art 11(4) OECD-MC Interest Connected with a PE
 - shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."



- Art 11(5) OECD-MC Sourcing Rule
 - ¬ First Sentence → "Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State."
 - Second Sentence → "Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."



Residence versus Source Taxation

- OECD-MC provides for exclusive residence State taxation of royalties (Art 12(1))
 - ¬ Almost half of OECD countries have reservations on Art 12 → Equipment leasing, source right to tax, source rule equivalent to interest
- UN-MC (Art 12(2)) and perhaps 75% of tax treaties provide for a limited right of taxation for the source State

Structure of Art 12 OECD-MC

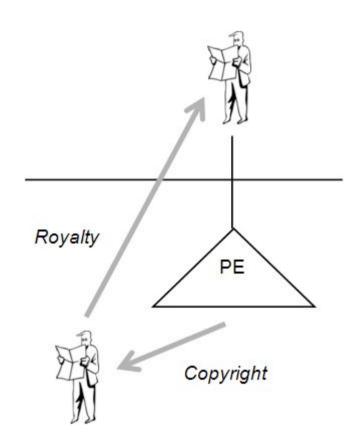
- Para 1 Residence State has exclusive right to tax royalties
 - "Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State." → Source ("arising") = Residence of the Payor (explicit sourcing rule in Art 12(5) UN-MC)
 - "... may be taxed ..." in Art 12(1) in UN-MC and limited source tax in Art 12(2) in UN-MC
- Para 2 Definition of Royalties (~ Art 12(3) UN-MC)
- Para 3 Art 12 does not apply to royalties from property effectively connected to a permanent establishment in the source country (~ Art 12(4) UN-MC) → Art 7
- Para 4 "Special Relationship Clause" (~ Art 12(6) UN-MC) → The restriction on the source country right to tax does not apply to the excess amount which has its basis in a "special relationship" ("Arm's Length")

Art 12 OECD-MC – Definition of Royalties

- "Royalties" means payments of any kind received as a consideration for the use of, or the right to use,
 - any copyright of literary, artistic or scientific work including cinematograph films
 - Software → Mere purchase of software protected by copyright is not a royalty (Art 12 Para 12 – 17.4 OECD Comm)
 - ... any patent, trade mark, design or model, plan, secret formula or process
 - Payment for the development of a design, model or plan that does not already exist is not a royalty, even if the designer (e.g. an architect) retains all rights, including the copyright.
 - ... or for information concerning industrial, commercial or scientific experience
 - ¬ Know-How → Supply of pre-existing information, remains secret, can be used repetitively, risk on user, does not require individual skill in each application (Art 12 Para 11.3 OECD Comm)
 - Distinguish from Services → May require use of special knowledge, skill or expertise but not the transfer of that special knowledge, skill or expertise – E.g., after-sales service, services under a guarantee, technical assistance, an opinion, advice provided electronically (Art 12 Para 11.4 OECD Comm)

- Art 12 OECD-MC Definition of Royalties
 - UN-MC
 - ... films or tapes used for radio or television broadcasting,
 - ... industrial, commercial or scientific equipment
 - ¬ Removed from Art 12 OECD-MC by the 1992 Update following the report "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" → Nature of income is business profits and practice of source State tax on gross income seemed too high.

- Art 12(3) OECD-MC Royalties
 Connected with a PE
 - not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."



Capital Gains – Art 13 OECD-MC

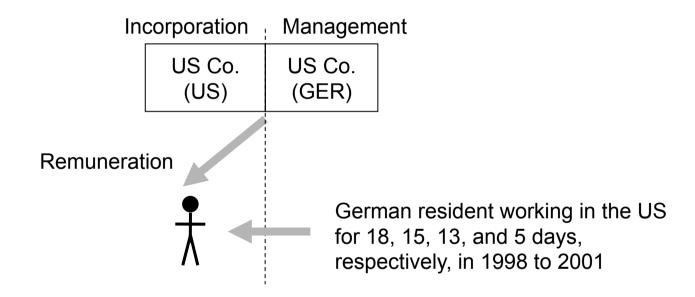
- "Mini-DTC" for Sales in Art 13 OECD-MC
- Structure of Art 13 OECD-MC
 - ¬ Para 1 Alienation of immovable property → Art 6
 - Para 2 Alienation of movable property forming part of the business property of a permanent establishment (movable property of a permanent establishment or the permanent establishment as such) → Art 7
 - Para 3 Alienation of ships or aircraft → Art 8
 - Para 4 Alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property in the source State → Art 6
 - Para 5 Alienation of other property (e.g., shares in a company (other than Art 13(4)), securities, bonds, debentures) → Art 21

Structure of Art 15 OECD-MC

- Para 1 Taxable "only" in the residence State unless exercised in the source State
 - Subject to Art 16 (Director's Fees), 17 (Artistes and Sportsmen), 18 (Pensions) and 19 (Government Service)
 - "... salaries, wages and other similar remuneration ..." → Also benefits in kind received in respect of an employment (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships) (Art 15 Para 2.1 OECD Comm).
- Para 2 Restriction of source taxation
- Para 3 Employment exercised aboard a ship or aircraft → Art 8

- Art 15 OECD-MC Restriction of Source Taxation
 - ¬ → Avoids source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source (Art 15 Para 6.2 OECD Comm)
 - Taxation in the source State if ...
 - ... the recipient is present in the source State for more than 183 days, or ...
 - "Days of Physical Presence" Method (Art 15 Para 5 OECD Comm)
 - ... the remuneration is paid by, or on behalf of, an employer who is a resident of the source State, or ...
 - Problem → "International Hiring-Out of Labour" → Employer is the person having rights on the work produced and bearing the relative responsibility and risks ("Substance over Form"; Art 15 Para 8 OECD Comm)
 - Discussion Draft (2004 and revised 2007) Six examples designed to provide guidance on who is the visiting employee's "employer" in substance
 - WP1 agreed in September 2007 to defer inclusion in Model, do further work on clarifying country positions
 - ... the remuneration is borne by a permanent establishment of the employer has in source State.

- Art 15 OECD-MC Dual Resident Employer
 - German Bundesfinanzhof, 18 September 2007, I R 1/96



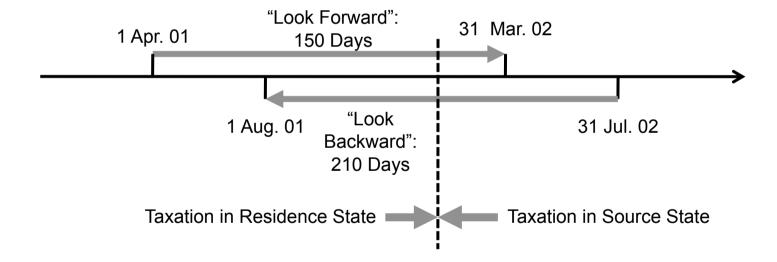
- Employer resident in both States under Art 4(1) OECD-MC (no tie-breaker, but rather MA procedure in the GER-US treaty), residency status for dual resident companies is only denied by Art 4(3) OECD-MC for treaty purposes concerning its own taxation and access to benefits, but not with respect to taxation of other persons
- GER has to grant treaty exemption as the remuneration is not "paid by [...] an employer who is not a resident if the other State" (Art 15(2)(b) OECD-MC)

- ¬ Art 15 OECD-MC Calculation of "Days of Physical Presence"
 - "Days of Physical Presence"
 - ¬ Included → Part of a day (however brief; no 8-hour-threshold, no overnight-threshold), day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness and death or sickness in the family (Art 15 Para 5 OECD Comm)
 - Not Included
 - Entire days spent outside the State of activity, whether for holidays, business trips, or any other reason
 - Days of transit in the course of a trip between two points outside the State of activity
 - Days while taxpayer was a resident of the source State (Art 15 Para 5.1 OECD Comm)

- 12-Month-Period

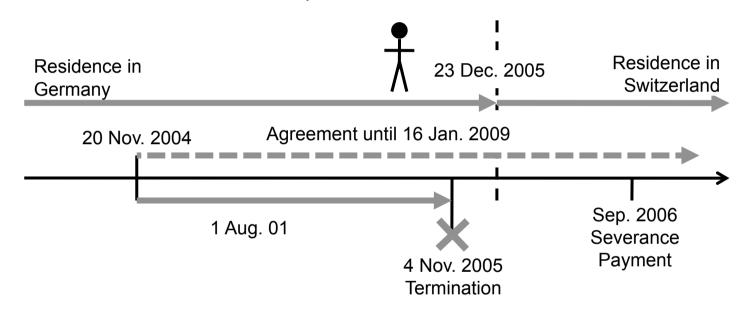
- "... in any twelve month period commencing or ending in the fiscal year concerned ..."
 - Previously (in 1977 OECD-MC): "... in the fiscal year concerned ..." Problem: Taxpayer is present last 5 ½ months of one year and the first 5 ½ months of the following year → OECD considered this "opportunities for tax avoidance"

- Art 15 OECD-MC Calculation of "Days of Physical Presence"
 - ¬ 12-Month-Period
 - "... in any twelve month period commencing ["look-forward-period"] or ending ["look-backward-period"] in the fiscal year concerned ..."
 - Example (Art 15 Para 4 OECD Comm)



Art 15 OECD-MC – Timing Issues

German Bundesfinanzhof, 2 September 2009, I R 111/08



- Limited tax liability in Germany under domestic law (severance payment considered as "wage")
- But German taxation excluded by Art 15 GER-CH since no additional remuneration in respect of an employment (but rather a compensation for the loss of the workplace)
- Contrary MA between GER and CH competent authorities not binding on Courts

Other Income – Art 21 OECD-MC

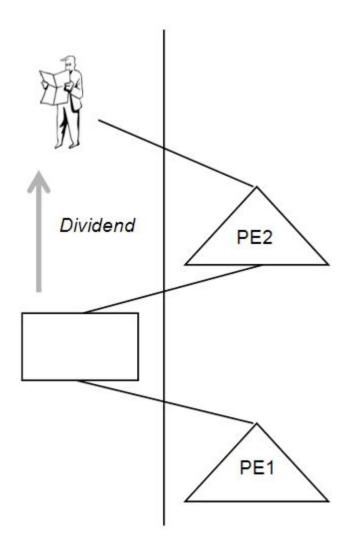
- ¬ General Rule → Income not dealt with in the foregoing Articles of the Convention
 - ... income of a class not expressly dealt with
 - ... income from sources not expressly mentioned
 - ... income from the residence State and income from third States (e.g., dualresidency issues)

Structure of Art 21 OECD-MC

- Para 1 Exclusive taxing right for the residence State → Art 4 allocates the taxation right in respect of third State income (Art 21 Para 2 OECD Comm).
- Para 2 Exception from the provisions of Art 21(1) where the income is associated with the activity of a permanent establishment which a resident of a Contracting State has in the other Contracting State.

Other Income – Art 21 OECD-MC

- Art 21(2) OECD-MC "Permanent Establishment"
 - "The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."



Part V Special and Final Provisions

Overview

Special Provisions

- Article 24 Non-discrimination
- Article 25 Mutual agreement procedure
- Article 26 Exchange of information
- Article 27 Assistance in the collection of taxes
- Article 28 Members of diplomatic missions and consular posts
- Article 29 Territorial extension

¬ Final Provisions

- Article 30 Entry into force
- Article 31 Termination

Non-discrimination – Art 24 OECD-MC

Structure of Art 24 OECD-MC

- Para 1 Non-discrimination because of nationality: no other or more burdensome taxation or requirement connected therewith
- Para 2 Non-discrimination of "stateless" persons
- Para 3 Non-discrimination of PEs: No less favourable taxation for non-residents with a PE in the taxing State
- Para 4 Non-discrimination of debtors: Deductibility of interest and royalties under the same circumstances when made to residents of the other State
- Para 5 Non-discrimination of foreign shareholders: no other or more burdensome taxation levied on companies with non-resident shareholders
- Para 6 Scope of application: discrimination may arise from any tax.

Non-discrimination — Art 24 OECD-MC

Modus operandi of Art 24 OECD-MC

- Applied after distributive rules → the distributive rules themselves cannot lead to discrimination (special issue: Art 9 OECD-MC?)
- Directly targeting domestic taxation → "second circle of protection" for the taxpayer → covering all kinds of taxes (wider scope than distributive rules!) and residents of neither Contracting State (outside the scope of Art 1 OECD-MC comp. Art 24 Para 1)
- ¬ Does not normally prevent double taxation (but see → Triangular Situations)
- ¬ Other / more burdensome taxation prohibited → alternative non-discriminatory rules have to be applied by authorities.

- Art 24 OECD-MC and EU Fundamental Freedoms

- Similar substantive scope of application in taxation → many issues are covered by both sets of rules, but EU Freedoms cover much wider range of cases
- Interrelations → EU Freedoms do not overlay Art 24, but provide an additional remedy for taxpayers within the EU; no direct impact of EU Freedoms on treaty non-discrimination; but Art 24 may effectively extend Fundamental Freedoms to third State's nationals under certain conditions.
- Important differences: No concept of justification for Art 24 OECD-MC!