Papers on Selected Topics in Administration of Tax Treaties for Developing Countries

Paper No. 7-A

May 2013

Taxation of Investment Income and Capital Gains

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1. Introduction

This paper will focus on both the domestic and tax treaty notions of investment income (namely, income from immovable property, dividends, interest and royalties) and capital gains. Attention will also be paid to some specific issues, including hybrid financing and thin capitalization. Furthermore, the administrative procedures for granting tax treaty benefits with respect to the aforesaid different types of income will be discussed. To this end, the paper will consider the allocation of taxing rights over these items of income and gains under the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] ("UN Model Convention") and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[2] ("OECD Model Convention")[3]. With respect to the treaty benefits, the main focus will be on the procedures for the granting of these benefits in the source state, but aspects of double taxation relief in the state of residence of the taxpayer will also be briefly dealt with. Only limited attention will be paid to treaty entitlement and anti-abuse issues, as these aspects are extensively covered in separate papers[4]. Finally, some specific aspects of enforcement will be discussed.

1 United Nations, Department of Economic and Social Affairs, *Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

2 Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (loose-leaf).

3 Any references to the UN Model Convention and Commentary are to the 2011 version unless otherwise noted. Similarly, any references to the OECD Model Convention and Commentary are to the 2010 version unless otherwise noted.

4 See Joanna Wheeler, Persons Qualifying for Treaty Benefits; and Philip Baker, Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion, Papers 2-A and 9-A of this collection respectively.

2. Relevant aspects of domestic law and tax treaties

2.1. General legal and administrative framework

As discussed in a separate paper[5], there is great diversity amongst countries on how the relationship between tax treaties and domestic law is regarded and whether additional legislation is required to give effect to tax treaties.

Generally, tax treaties are given supremacy over domestic law[6], leaving aside incidental cases of treaty override.

Absence of any more specific legislative rules or administrative procedures and guidance, may create serious obstacles to taxpayers to effectively enjoy the tax treaty benefits and, thus, may jeopardize the aim of concluding tax treaties. According to the general tax doctrine followed by most countries, tax treaties do not create new domestic taxing rights, but can limit the application of existing domestic tax law. They also do not contain rules on how taxes are levied. In view of that, it is necessary to provide a general overview, first, of the various domestic tax laws to see whether, and if so how, the types of income and gains dealt with in this paper are defined and, then, of how the tax on these items of income and gains is levied. Finally, the effect of tax treaty application is briefly discussed.

2.2. Domestic definition and source of investment income and capital gains

As there are no generally internationally applicable standards for taxation, the definitions of these types of income differ to a large extent in the various countries. They may even differ between various types of law and between different tax laws within each country. In this paper, the focus will be on the main lines of the definitions as generally used in income and corporate (or specific withholding tax) laws.

2.2.1 Income from immovable property

Generally, a rather broad notion of immovable property is used. It may cover not only tangible property like land, houses, office buildings, factories, but also certain intangible rights vested on

5 See Brian Arnold, Overview of Major Issues in the Application of Tax Treaties, Paper 1-A of this collection.

6 See Article 26 and 27 of the Convention on the Law of Treaties, Vienna, 23 May 1969.

immovable property, like usufruct[7], rights to explore or to exploit certain natural resources, or loans secured by mortgage. Also, the notion of income may be broad, covering income of any form of exploitation, like letting, leasing, or even time-sharing[8].

2.2.2 Dividends

A wide range of definitions of dividends is found in domestic tax laws. Generally, the definition covers formal distributions of profits by companies, as regulated in company law, based on shareholding. However, also distributions of profits by other entities based on participation in such entities, or payments on the basis of other rights to profits of a company or of an entity, may be covered. Dividends covered may include both payments in cash or in kind. Moreover, informal distributions (such as benefits granted by a company to its shareholders in the form of products delivered at a rebate, or even for free) may be covered. Furthermore, payments on profit sharing bonds may be treated as dividend for tax purposes. Finally, in several countries, payments regarding so-called hybrid forms of financing, or interest paid in case of excessive loan financing (under so-called thin capitalization legislation) may be treated as dividends[9].

2.2.3 Interest

As regards interest, less diversity seems to exist as most tax legislation seems to define this as income from all types of debt claims. The definition of interest may cover more than just formal payments of interest. For instance, in case of debt issued below par value, the difference between the amount actually lent out and the amount received at the time of redemption of the debt claim may fall within the scope of such definition. Generally, it also comprises premiums and prizes attached to debt claims. However, differences may exist among countries as to whether the definition of interest also covers income from profit sharing bonds, hybrid forms of financing, excessive financing, or

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7 A term developed in civil law countries to indicate an in rem right whereby a person may use a certain property and take all the advantages and income there from, even though the property is legally owned by another person, subject to the condition that the holder does not change, damage or sell the property (IBFD International Tax Glossary).

8 For instance, this is the situation where, a person, who owns shares in a company that holds immovable property, receives an entitlement to use (part of) the immovable property during a certain period of time (depending on the number of shares held) instead of receiving a dividend in cash.

9 These situations are briefly dealt with infra, in section 2.3.

excessive interest[10] paid to a related lender (which interest, sometimes, may be treated as a dividend). Finally, there may be differences also in the treatment of guarantee fees received on loans provided.

2.2.4 Royalties

Generally, the definition of royalties covers any payments for the use of intellectual property rights as defined in intellectual property law, like copyrights, patents, trade marks etc, as well as for the use of know how. However, some countries also treat payments for the sale of such rights as royalties. Moreover, the borderline between use and sale is sometimes drawn differently. Different approaches also exist as to whether or not payments for the use of films and tapes or for the leasing of various types of equipment are included in the definition of royalties. The treatment of payments for software may also differ to a certain extent among countries. Excessive payments to a related company may not be considered as royalties and are sometimes treated as a dividend.

2.2.5 Capital gains

With respect to capital gains, the tax treatment varies to a large extent among countries, i.e. from taxing none, to taxing some or even all gains. If taxable, such gains may either fall within the scope of general taxes on income, or be levied in the form of a separate tax. Also, within one country, differences in treatment of capital gains may exist among the various types of taxes. For instance, some countries do not levy a capital gains tax on individuals, unless the property alienated was part of a business. Moreover, whereas some countries levy a tax on capital gains derived by a non-resident company selling shares in a company that is a resident of their country, other countries do not tax capital gains in that situation at all, or only if the non-resident shareholder held a substantial interest in the company. Finally, some countries exempt such gains in intercompany situations.

Where defined, these gains generally include gains derived from the alienation of (certain types of) assets. However, they may also include deemed gains, which are considered as realized for tax purposes, in case of other forms of transfer of ownership, such as in case of gift or death, or transfer of assets across the border to another country. They may also include unrealized book revaluations.

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[10] Generally speaking, an interest payment between related companies could be considered excessive in as far as the amount of the interest payment exceeds the amount which independent parties would have agreed to. For instance, if an interest rate of 10% was charged, whereas independent parties would only have agreed to a rate of 8%, an amount corresponding to a rate of 2% of the interest payment would be considered as excessive.

2.2.6 Source of income or gains

For the purposes of domestic taxation of cross border investment income and capital gains, it is generally critical to identify in which country the income is considered to have its source. In the case of income from immovable property, that will generally be the country where the property is located, although several countries may also consider the country from where rental payments are made as the place of source, whereas others may also consider the income to have its source where the rental contract was signed. Technically more complex issues may arise in the case of intangible property, like certain rights and shares, as the place where they are located may be less clear. In the case of dividends, the source is generally in the country where the company or other entity making the distribution is established, albeit also the country from where the payment of dividend is made may consider it to have its source there. In the case of interest and royalties, the source will generally be in the state in which the payer is a resident, but under some domestic legislation other criteria may apply, such as the place where the contract was signed, or where the money or intellectual property was used. In the case of capital gains, the source is generally identified in the country where the property is located, whereas different approaches may exist regarding the location of intangible rights like shares. Moreover, the place where the contract is signed may be considered as the place of source.

2.3. Hybrid financing and thin capitalization

Hybrid financing relates to forms of financing which have characteristics both of a loan and of equity capital. Hybrid financing may be used for valid economic reasons, for instance in the financial sector in view of capitalization requirements. However, it is also frequently used in tax planning in order to realize tax savings by exploiting a different classification of the financing in the countries involved. Thus, a hybrid loan may be recognized as a loan in the country of the debtor, allowing for deductibility of the interest paid on it, whereas in the country of the creditor it may, under a substantive determination, be considered as equity capital. The creditor country may then consider the “interest” received as dividends, which - in intercompany situations - may be tax exempt under a participation exemption regime. Countries may use various criteria (alone or in combination) to determine whether a formal loan is considered hybrid and should be re-classified as equity capital[11].

[11] These may include:
- interest payable depends on the profitability of the debtor;
- no repayment, or a very long repayment schedule;
- subordination of repayment to claims of other creditors.

Some countries which re-classify a formal loan into equity capital subsequently treat the interest paid by the debtor as a dividend, on which the withholding tax on dividends may be applied.

Thin capitalization relates to excessive debt financing of a company or other entity. In the case of thin capitalization legislation, the interest paid on debt claims (real loans), is no longer tax deductible insofar as the debt exceeds a certain ratio between debt and equity capital[12]. Also, in this case the source country may re-classify the non-deductible interest into dividends on which dividend a (withholding) tax may apply.

2.4. Ways of assessment and enforcement of the taxes

The modalities, through which taxes are levied on different types of investment income, as well as capital gains, vary to a large extent among countries. These different ways of levying taxes under domestic law have an impact on how to apply tax treaties.

2.4.1 Withholding tax

Source states generally impose taxation on dividends, interest and royalties derived from their country by non-resident taxpayers by means of obliging the payer of the income to withhold tax at a certain percentage from the gross amount of the payment[13]. Domestic legislation may often contain different rates for different kinds of income. Sometimes, there are (temporarily) reduced rates or even exemptions to promote foreign investment, or the granting of foreign loans or licenses. Such systems are relatively easy to administer by the withholding agents and the tax inspectors competent for them, and very useful in the enforcement of such taxation, as the payer (generally speaking the withholding agent who is responsible for withholding the tax) generally do not want to run the risk of having to pay taxes and fines if no, or insufficient, tax is withheld. So, only limited fiscal intelligence efforts may need to be undertaken to discover tax evasion.

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[12] Generally, such legislation is only applicable in cross border situations between related companies or other related entities, as it is aimed at combating erosion of the tax base in the source country by very large (tax deductible) payments of interest to related non-resident companies, which are subject on that income to no tax, or substantially lower tax, in their countries, as compared to the tax applicable in the source country.

[13] The payer, or withholding agent, is then obliged to transfer the tax withheld to the appropriate tax authority. Generally, no tax return needs to be filed by the taxpayer and the tax withheld represents a final tax due in that country.

2.4.2 Taxation by assessment

In the case of income from immovable property and capital gains, however, tax is often levied by means of assessment (albeit in the case of cross border payment of rent, tax legislation may often provide for a withholding tax to be withheld by the payer of the rent).

The reasons for levying the tax by assessment may be that the income or gain is taxable on a net basis (so the taxpayer is enabled to take certain deductions into account when reporting such income), or because there is not necessarily a cash flow from the source country to the other state and thus no resident payer to withhold tax[14].

In levying taxes by assessment, two systems should be distinguished: self-assessment, and assessment by the tax authorities[15].This distinction can also have an impact on the way in which the provisions of tax treaties apply.

Obviously, when levying tax by assessment, proper enforcement is more difficult, as no third party is obliged to report and withhold the tax and, thus, the tax authorities have to rely on the proper disclosure and reporting of the income by the non-resident taxpayer. As a result, probably more fiscal intelligence is needed to avoid tax fraud. Obviously, such intelligence is much more difficult if the income is received by a non-resident taxpayer from another non-resident, as there is no pay trail or deduction as costs by the payer visible in the source state. The source state and also the state of residence where the income may not have been reported, thus, need a sufficient legal basis and resources to do audits and investigations[16].

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[14] This latter case, for instance, may occur when a non-resident owns a holiday home in the source country, which is rented out to another non-resident, so that the cash flow takes fully place outside the source state.

[15] Under self-assessment, the taxpayer files the tax return in which all deductions and benefits are taken into account, and then also pays the tax due. In this system the tax assessment is final, unless the tax authorities upon audit make a re-assessment. Under assessment by the tax authorities, the taxpayer files a tax return and afterwards the tax authorities make the assessment after having judged the correctness of the return.

[16] It would go beyond the scope of this paper to expand on such issues, as these are basically not different from purely domestic situations, albeit the challenges might be much bigger, especially if both the payer and the recipient are non-resident. To address this issue, some countries have not only imposed a reporting obligation on all recipients of taxable income, but also a withholding obligation on non-resident payers of the income (for instance, in the case of sale of shares of a company resident in the source state, on the non-resident buyer who made a payment to a non-resident seller). Obviously, the enforcement of reporting requirements or withholding obligations on a non-resident is more complex, especially for developing countries which generally have less resource to assure such enforcement.

2.5. Effect of tax treaties and their application

As discussed above in section 2.1., it is assumed that the provisions of tax treaties will generally prevail over the provisions of domestic law[17], and that they generally do not create new taxing rights for a country.

In order to further understand the effect of tax treaties, it is critical to understand that, in tax treaties, taxing rights on each of the items of income and gains dealt with are allocated either exclusively to one country or are shared between the two countries. This means that the domestic taxing rights may be limited by the allocation of taxing rights under the treaty. Furthermore, it means that taxing rights may be allocated by a tax treaty to a country, which do not exist in its domestic law.

Besides the allocation provisions, other provisions are included in tax treaties, such as the ones on non-discrimination, which are mentioned in a separate paper[18] and which will not be discussed further in this paper[19].

Against the background of what was mentioned above, the following aspects are of importance when applying a tax treaty:

- How are the taxing rights allocated for each type of income and gains and how are the latter defined?
- Who is allowed to claim the treaty benefits?
- How can it be assured that the treaty is properly applied so that a taxpayer can realize the benefits of either a lower taxation in the source state, or of relief for double taxation in the residence state as foreseen in the tax treaty?

Before addressing these aspects in the following sections, it is useful to briefly discuss the situation where a tax treaty allocates a taxing right to a country, which does not (yet) have such right under its domestic tax law. As tax treaties are generally considered not to create new domestic taxing rights, such right can then not be exercised by the relevant country. Thus, if a tax treaty allocated the right to a country to levy a tax of 10 % on the gross amount of interest paid to the resident of the other country, and the source country did not impose such taxation under its domestic law, generally

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17 Either directly or via incorporation of the tax treaty in the legal system.

18 See Brian Arnold, Overview of Major Issues in the Application of Tax Treaties, Paper 1-A of this collection.

19 In case countries are allocated taxing rights under tax treaties, which allow them to fully tax the income in accordance with their domestic law, it should be borne in mind that this does not mean that they would not have to respect any relevant non-discrimination provision included in the relevant treaty.

speaking the source country could not levy such tax. This aspect might, or should have, played a role during the tax treaty negotiations.

3. Treaty allocation of taxing rights and treaty definitions with respect to investment income and capital gains

3.1. General aspects

In the following sections, the allocation of taxing rights over investment income and capital gains, as well as how these items of income and gains are defined in tax treaties will be discussed. It is important to understand that such definition or classification only applies for the purposes of the allocation of taxing rights under tax treaties and has no direct bearing on the classification of such income or gains under domestic law, or on the system of levying taxes under domestic law. For treaty allocation purposes, only the treaty definition is decisive, unless that definition also refers to domestic law, or itself contains terms not defined in the treaty. In this last case, under Article 3, paragraph 2, of both the UN and the OECD Model Conventions, the terms have to be interpreted on the basis of domestic law, unless the treaty context otherwise requires.

Finally, also situations in which the two contacting parties classify the income differently for treaty purposes will be briefly discussed; such situations are referred to as “conflicts of qualification” in the Commentaries to the OECD Model.

3.2. Income from immovable property

According to Article 6, paragraph 1 of both the UN and the OECD Model Conventions, income from immovable property derived by a resident of one country from immovable property situated in the other country, may be fully taxed in the country where the immovable property is situated in accordance with its tax legislation. In that case, the country of residence of the recipient of the income may also fully tax such income, but must then provide relief for the tax levied in the source country, under Article 23 of both the UN and the OECD Model Conventions.

The definition of immovable property included in Article 6, paragraph 2, of both the UN and the OECD Model Conventions is identical, and refers for the meaning of immovable property to the laws of the country in which the property is situated. The definition, however, also explicitly includes accessory property as well as livestock and equipment used in agriculture and forestry, and

several other rights, including usufruct on immovable property and rights to payments regarding the working of or the right to work mineral deposits, and finally excludes ships, boats and aircraft. Despite the reference to domestic law of the source country, artificial deeming provisions might probably still be challenged under the general treaty principle of "good faith", as provided under Article 26 of the Vienna Convention on the Law of Treaties[20].

It is mentioned [21] that no provisions are included in Article 6 of both the UN and the OECD Model Conventions on income from debt claims secured by mortgage; as such income is classified as interest under Article 11 of these Model Conventions.

Article 6, paragraph 3, of both the aforesaid Model Conventions makes clear that also the term income is to be interpreted broadly, covering income from the direct use, letting, or use in any form of immovable property.

As the definition of income from immovable property is very broad and there are no limitations in the treaty as regards the level of taxation in the source country (nor with respect to either taxation of such income on a net or on a gross basis), this provision will probably rarely lead to a limitation of the taxing rights of the source country and, thus, generally not require specific arrangements for the taxpayer to be able to claim specific treaty benefits[22].

3.3. Dividends

Under Article 10 of both the UN and the OECD Model Conventions, the taxing right on dividends paid by a company resident in one country[23] to a resident of the other country is shared in the sense that the former country may levy a tax on such dividends which is limited to a certain percentage of the gross amount of the dividends if the beneficial owner[24] is a resident of the other country. In the OECD Model Convention the tax is limited to 5 percent of the gross amount of the dividends for

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20 See footnote 6.

21 Paragraph 7 of the Commentary on Article 6 of the UN Model Convention and paragraph 2 of the Commentary on Article 6 of the OECD Model Convention.

22 For the sake of completeness, reference is made to paragraph 4 of the Commentary on Article 6 of the UN Model Convention, where the specific situation of time sharing is briefly discussed and to paragraph 3 of the Commentary on Article 6 of the OECD Model Convention, which deals with the specific situation of Real Estate Investment Trusts (REITs)..

23 So, the country of source of the dividends is determined in the treaty.

24 On the notion of beneficial owner, see Joanna Wheeler, Persons Qualifying for Treaty Benefits; and Philip Baker, Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion, Papers 2-A and 9-A of this collection.

qualifying participations, and 15 percent of the gross amount for portfolio participations. In the UN Model Convention, the percentages are left open to be established during the bilateral negotiations.

It should be noted that the threshold of participation required to be able to benefit from the lower rate for qualifying participations is lower in the UN Model Convention than in the OECD Model Convention (respectively 10% and 25% of the capital of the company paying the dividends).

Finally, under Article 10, paragraph 4, of both the UN and the OECD Model Conventions, there is no limitation of the taxing rights of the source country, in case the dividends paid are attributable to a permanent establishment that an enterprise resident in the other country maintains in the source country[25]. In such cases, the source country is allowed to fully tax the dividends as part of the profits of the permanent establishment under Article 7. As there is no treaty benefit regarding the taxation of the dividends in the source country, this situation will not be further discussed.

In all of these cases, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief, under Article 23 of both the UN and OECD Model Conventions, for the tax levied in the source country.

The definition of dividends as provided in Article 10, paragraph 3, of both the UN and the OECD Model Conventions is identical. It lists the income from the most commonly used types of shares, and other rights, not being debt claims, participating in the profits and ends with an open formula that also includes income from other corporate rights which is treated the same as income from shares by the laws of the country of which the company making the distributions is a resident. Thus, the definition is open ended, and in many countries it also covers the distributions of profits by limited liability companies and by co-operative societies. It can equally cover distributions by non-transparent partnerships subject to the same taxation on the profits as companies, but not income from debt claims participating in the profits, nor income from convertible debentures[26]. Furthermore it is clarified[27], that the notion of dividends not only covers dividends decided by the general meeting of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses,

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[25] Article 10, paragraph 4, of the UN Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of this Model Convention (not included in the OECD Model Convention) and the dividends received are attributable to a fixed base maintained by the resident in the source country.

[26] Paragraph 14 of the Commentary on Article 10 of the UN Model Convention, quoting paragraphs 24, 26 and 27 of the Commentary on Article 10 of the OECD Model Convention.

[27] Paragraph 14 of the Commentary on Article 10 of the UN Model Convention, quoting paragraph 28 of the Commentary on Article 10 of the OECD Model Convention.

profits on liquidation, and disguised distribution of profits. Finally, it is also clarified[28] that dividends as meant in this Article also include interest on loans insofar as the lender effectively shares the risks run by the company. Thus, Articles 10 and 11 do not prevent such interest to be treated as dividends under domestic thin capitalization rules. It is also clarified that whether the lender shares the risks of the company must be determined in each individual case in the light of all the circumstances, including the following:

- The loan very heavily outweighs any other contribution to the capital and is substantially unmatched by redeemable assets;
- The creditor will share in any profits of the company;
- Repayment is subordinated to other creditors or to payments of dividends;
- The level of interest depends on the profits;
- No fixed provisions in the loan contract for repayment by a definite date.

This clarifies the treatment of interest as dividends for tax treaty purposes in the case of hybrid financing and of thin capitalization legislations mentioned above in section 2.3.

Due to this broad open treaty definition of dividends, domestic definitions of treaty countries will almost always be covered under the treaty definition. There could be, however, very specific cases where careful interpretation has to take into account the object and purpose of the treaty. A common element in the discussion on the treaty notion of dividends in the Commentary on Article 10, paragraph 3, of both the UN and the OECD Model Conventions seems to be that there should be a distribution of income by the company or other entity covered. That would seem to imply that, for instance, the income derived from the sale of shares would generally not be covered by Article 10, but by Article 13, even though the source country treated it as a dividend under its domestic law, as there is an alienation of the shares in the company covered by Article 13, and not a distribution of income by the company[29].

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[28] Paragraph 14 of the Commentary on Article 10 of the UN Model Convention, quoting paragraph 25 of the Commentary on Article 10 of the OECD Model Convention.

[29] This might perhaps be different where, as part of a set of artificial transactions, the main purpose of which would be benefiting of a more favorable tax treatment by transforming dividends into a capital gain, such capital gain could be re-classified as dividends for domestic law purposes, under a general anti-abuse provision, such as substance over form, and then also for treaty purposes, if this were in circumstances where the more favorable treatment as capital gain would be contrary to the object and purpose of the relevant treaty provisions.

In the case of dividends, generally speaking there is a need to make special arrangements for taxpayers to be able to claim the treaty benefits, as the amount of tax which the treaty allows to be levied on the dividends in the source country (mostly levied via a withholding tax system) may be lower than the amount of tax due on the dividends under its domestic law, whereas it should also be established whether the treaty requirements for the entitlement to such reduction of tax (for instance beneficial ownership and, where relevant, the participation threshold) are met. Such procedures are dealt with in section 4.4. of this paper.

3.4. Interest

Under Article 11, paragraphs 1 and 2, of both the UN and the OECD Model Conventions, the taxing right on interest arising in one country and paid to a resident of the other country is shared in the sense that the former country may levy a tax on such interest, which is limited to a certain percentage of the gross amount of the interest if the beneficial owner is a resident of the other country. In the OECD Model Convention the tax is limited to 10 percent of the gross amount of the interest, whereas in the UN Model Convention, the percentage is left open to be established during the bilateral negotiations.

According to Article 11, paragraph 5, of both Model Conventions, interest is for treaty purposes deemed to arise in a country if it is paid by a resident of that country, or if it is borne by a permanent establishment which the resident of the other country maintains in the former country[30]. Thus, like in the case of dividends, the country of source of the interest income is defined in the tax treaty.

Finally, under Article 11, paragraph 4, of both Model Conventions, there is no limitation of the taxing rights of the source country, in case the interest paid is attributable to a permanent establishment that an enterprise resident in the other country maintains in the source country[31]. In such cases, the source country is allowed to fully tax the interest as part of the profits of the

[30] Article 11, paragraph 5, of the UN Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the interest received is attributable to a fixed base maintained by the resident in the source country.

[31] Article 11, paragraph 4, of the UN Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the interest received is attributable to a fixed base maintained by the resident in the source country. It also allows for taxation of the interest as part of the profits of a permanent establishment in case the interest is attributable to it under Article 7, paragraph 1, letter c, of that Model Convention.

permanent establishment. As there is no treaty benefit regarding the taxation of the interest in the source country, this situation will not be further discussed.

In all of the cases where the source country is allowed to tax the income, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief under Article 23 of both Model Conventions for the tax levied in the source country.

The definition of interest in Article 11, paragraph 3, of both the UN and the OECD Model Conventions is identical. In this case, it is a closed (or exhaustive) treaty definition, which is not referring to domestic law. The core elements of the definition are as follows: income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the profits of the debtor, income from government securities, bonds and debentures, including premiums and prizes attaching to such securities. It is also explicitly mentioned that penalty charges for late payments are not regarded as interest. It is clarified that such closed-definition of interest was considered possible as the definition practically covers all the types of income regarded as interest in the domestic laws of countries[32]. It is also mentioned [33] that payments made under non-traditional financial instruments where there is no underlying debt (such as various types of interest rate swaps) are generally not considered as interest, unless a loan is deemed to exist under an anti-abuse provision, such as substance over form or a similar doctrine[34].

Furthermore, it should be noted that in both the UN and the OECD Model Conventions a provision (Article 11, paragraph 6) has been included which makes clear that in the case of a special relationship between the beneficial owner and the payer or between both of them and some other person, the provisions of this Article only apply to the part of the interest which would have been agreed upon had they dealt with each other on an at arm's length basis. For the notion of special relationship, reference is made in both the UN and the OECD Commentaries[35] to Article 9 on Associated Enterprises. As regards the classification of the excessive part of the payment for

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[32] Paragraph 19 of the Commentary on Article 11 of the UN Model Convention, quoting paragraph 21 of the Commentary on Article 11 of the OECD Model Convention.

[33] Paragraph 19 of the Commentary on Article 11 of the UN Model Convention, quoting paragraph 21.1 of the Commentary on Article 11 of the OECD Model Convention.

[34] For a discussion of approaches used by countries to address the improper use of treaties, including the substance over form and other judicial doctrines, see the Commentary on Article 1 of the UN Model Convention.

[35] Paragraph 22 of the Commentary on Article 11 of the UN Model Convention, quoting paragraphs 33 and 34 of the Commentary on Article 11 of the OECD Model Convention. Besides the reference to Article 9, it is also mentioned that relationship of blood, or marriage and, in general, any community of interests as distinct from the legal relationship regarding the payment of interest, are covered.

domestic and treaty purposes, all relevant circumstances must be taken into account[36]. For instance, if the payment was made by a company to its shareholder, the excessive amount may perhaps be treated as a dividend under the domestic tax law of the payer, and thus also as a dividend for tax treaty purposes[37].

In the context of tax treaty administration and from a practical point of view, it is also important to mention that many treaties provide for different maximum rates of tax with respect to different types of interest. This partly relates to the fact that, mainly for practical and enforcement reasons, in most countries the tax on cross border interest payments is levied via a withholding tax on the gross amount of the interest paid. This might lead to a very high effective tax on creditors in case they had incurred considerable expenses to fund the loan[38]. Such high taxation could lead to it being passed on to the debtors in the form of increased interest due on the loans, which would be unfavorable for the business in the source country. In other cases, there are other economic reasons (like in the case of government loans or loans provided by pension funds) to lower the tax treaty rate in order to make it more attractive for such creditors to provide funding to projects in the source country. This topic is more elaborately discussed in the Commentaries on both the UN and the OECD Model Conventions[39].

In case the amount of tax which is allowed to be levied under the treaty in the source country is lower than the amount of tax due (mostly via a withholding tax system) under the domestic law of that country, there will be a need to make special arrangements to allow the taxpayers to claim the treaty benefits. These arrangements are also needed in view of the verification of the requirements for the entitlement to the treaty benefits (for instance, beneficial ownership and, where relevant, the type of interest). Such procedures are dealt with in section 4.4.

3.5. Royalties

As there are fundamental differences between the UN Model Convention and the OECD Model Convention regarding Article 12, this article seems to pose more problems in terms of tax treaty administration than the articles on other types of income discussed above.

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36 Paragraph 22 of the Commentary on Article 11 of the UN Model Convention, quoting paragraphs 35 and 36 of the Commentary on Article 11 of the OECD Model Convention.

37 This would allow the country of the payer to levy tax up to the maximum percentage, as specified for dividends in the tax treaty, on the gross amount of the excess payment.

38 Such as in the case of financial institutions.

39 Paragraphs 11-17 of the Commentary on Article 11 of the UN Model Convention and paragraphs 7.1-7.12 of the Commentary on Article 11 of the OECD Model Convention.

First of all, under Article 12, paragraph 1, of the OECD Model Convention, the taxing rights over royalties arising in a treaty country and paid to a resident of the other country, who is the beneficial owner of the income, are exclusively allocated to the residence country of the recipient. Under Article 12, paragraphs 1 and 2, of the UN Model Convention, however, taxing rights are shared between the source country and the residence country of the recipient and the maximum rate of tax allowed to be levied in the source country on the gross amount of the royalties is left open for tax treaty negotiations, like in the articles on dividends and interest.

Under Article 12, paragraph 5, of the UN Model Convention[40], royalties are deemed to arise, for treaty purposes, in a country if they are paid by a resident of that country, or if they are borne by a permanent establishment which the resident of the other treaty country maintains in the former country. Thus, like in the case of dividends and interest, the country of source of the royalties is determined by the treaty.

Finally, under Article 12, paragraph 3, of the OECD Model Convention and Article 12, paragraph 4, of the UN Model Convention[41], there is no limitation of the taxing rights of the source country, in case the royalties paid are attributable to a permanent establishment that an enterprise resident in the other treaty country maintains in the source country. In such cases, the source country is allowed to fully tax the royalties as part of the profits of the permanent establishment. As there is no treaty benefit regarding the taxation of the royalties in the source country, this situation will not be further discussed.

In all of the cases where the source country is allowed to tax the income, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief in accordance with Article 23 of both the UN and the OECD Model Conventions for the tax levied in the source country.

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40 Article 12, paragraph 5, of the UN Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model) and the royalties received are attributable to a fixed base maintained by the resident in the source country.

41 Article 12, paragraph 4, of the UN Model Convention contains a similar rule in case the resident of the other country is covered by Article 14 of that Model Convention (not included in the OECD Model Convention) and the royalties received are attributable to a fixed base maintained by the resident in the source country. It also allows for taxation of the royalties as part of the profits of a permanent establishment in case the royalties are attributable to it under Article 7, paragraph 1, letter c, of that Model Convention.

Albeit the larger part of the definition of royalties in both the UN and the OECD Model Conventions is the same, there are some important differences[42]. The common element in the definition is the coverage of payments of any kind for the use, or right to use, any copyright of literary, artistic or scientific work including cinematographic films (referred to as copyright royalties), any patent, trade mark, design or model, plan, secret formula or process (referred to as industrial royalties), or for information concerning industrial, commercial or scientific experience (frequently referred to as payments for know how and basically covering undisclosed knowledge and experience).

Under the UN Model Convention, however, the definition of royalties includes also the payments for the use, or right to use, films or tapes for radio or television broadcasting, and payments for the use, or right to use, industrial, commercial and scientific equipment (the latter being referred to as payments for leasing).

Besides these very relevant differences between the text of the UN and the OECD Model Conventions, there are substantial issues of interpretation which are dealt with in a different level of detail in the Commentaries to these Model Conventions. Thus, there are considerable chances that the interpretation of the term royalties under treaties deviates from its interpretation under domestic laws[43].

Finally, it should be noted that in both Model Conventions a provision (Article 12, paragraph 6, of the UN Model Convention and Article 12, paragraph 4, of the OECD Model Convention) has been included, which makes clear that in the case of a special relationship between the beneficial owner and the payer, or between both of them and some other person, the provisions of the article only

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[42] See Article 12, paragraphs 3 of the UN Model Convention and Article 12, paragraph 2 of the OECD Model Convention.

[43] For instance, relevant issues may include:

- the borderline between certain types of rights to use and partial sales;
- the borderline between royalties and fees for technical services and also mixed contracts (some treaties include provisions on technical services in the royalty article or include a separate article on these services);
- the borderline between use of know how, services and rental income in the context of satellites and other means of communication;
- the borderline between royalties and rights to distribute products and services;
- the specific aspects of the use and transfer of various types of software;
- the provision of different rates for different types of royalties.

For a comprehensive discussion of these issues, see the Commentaries on Article 12, paragraph 3, of the UN Model Convention and on Article 12, paragraph 2, of the OECD Model Convention.

apply to the part of the royalties which would have been agreed upon had they dealt with each other on an at arm's length basis[44].

Albeit the definition of royalties is rather broad, there are still considerable chances that the domestic notion and the treaty notion deviate due to the interpretation issues mentioned above. In case the amount of tax which is allowed to be levied under the treaty in the source country is lower than the amount of tax due (mostly via a withholding tax system) under the domestic law of that country, there will be a need to make special arrangements to allow the taxpayers to claim the treaty benefits. These arrangements may also be needed in view of the verification of the requirements for the entitlement to the treaty benefits (for instance, beneficial ownership and, where relevant, the different types of royalties). Such procedures are dealt with in section 4.4 of this paper.

3.6. Capital gains

The texts of Article 13 as included in both the UN and the OECD Model Conventions contain several special features, including:

- There is no definition of capital gains in both the UN and the OECD Model Conventions, due to the great diversity in taxing such gains between the domestic tax laws of the countries;
- Capital gains related to quite different types of income are covered;
- There are major differences between the aforesaid Model Conventions in the allocation of taxing rights regarding gains on the sale of shares;
- For some gains the allocation of taxing rights is shared between the source and the residence country; in such cases, however, there is no limitation on the taxation in the source country. For other gains, there is an exclusive taxing right allocated to the residence country;
- Taxes on these gains are usually levied on a net basis (proceeds minus purchase price or book value) and, therefore, mostly by assessment, which may lead to additional enforcement issues.

Albeit there is no definition of capital gains in the text of both the UN and the OECD Model Conventions, the Commentaries thereto clarify what the scope of this notion may be[45]. Capital gains

[44] See section 3.4 of this paper, where a similar situation has been discussed with respect to interest.

may thus include gains made in the context of alienation, or other transfers of ownership like in the case of gifts or death, but also cases of emigration of the owner and or the assets, and in some countries also in case of revaluations of book values.

Article 13, paragraphs 1, 2 and 3, of both the UN and the OECD Model Conventions deal respectively with cross border gains on directly held immovable property, assets belonging to a permanent establishment in the other country, and ships and aircraft operated in international traffic and boats used in inland waterways transport including movable property pertaining to the operation by such means of transport. The allocation of the taxing rights follows the same allocation as the income from such activities as provided in Articles 6, 7, and 8, respectively. If tax is levied, that is usually done via assessment, with the consequent enforcement problems of being informed of the transactions and securing that the tax due can be effectively levied.

Article 13, paragraph 4, of both the UN and the OECD Model Conventions deals with capital gains which a resident of a country derives from the indirect sale of immovable property situated in the other treaty country, via the alienation of the shares in a company (or, in the case of the UN provision, also interests in other entities) that owns the property, provided that the value of such shares (or, in the case of the UN provision, the value of the assets owned by such company or entity) is derived directly or indirectly for more than 50% from such immovable property. In such a case, the country where the immovable property is situated may tax the gains on the sale of the shares, without limitation. The provision is intended to make it impossible to avoid source taxation, as provided for under Article 13, paragraph 1, by holding the immovable property situated in the other country indirectly via a company or other entity and by subsequently alienating the shares or other participations instead of the immovable property itself. The tax is usually levied by assessment on the net amount of the gain. The tax may be difficult to enforce in the source country, in particular if the company or entity is a resident of the other country, or if the seller or buyer is not a resident of the source country, or in the case of sale of shares or participations in companies or other entities that, in turn, own directly or indirectly, through a corporate chain, the company or entity which owns the immovable property. In case the buyer is a resident of the source country it may be easier to find information helpful to secure the enforcement of the taxation on the seller, but in case of a non-resident buyer, reporting requirements or withholding obligations imposed on the gains may be difficult to enforce.

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[45] Paragraph 4 of the Commentary on Article 13 of the UN Model Convention, quoting paragraphs 5-11 of the Commentary on Article 13 of the OECD Model Convention.

Article 13, paragraph 5, of the UN Model Convention also allocates an unlimited taxing right to the source country in the case of the alienation by a resident of the other treaty country of shares directly held in a company resident in the source country. It only applies if the shareholder held directly or indirectly at least a certain percentage (to be determined in the negotiations) of the shares in the company, at any time during the 12-month period preceding the alienation of the shares. The tax is usually levied by assessment on the net amount of the gain, and similarly difficult to enforce in the source country.

For all other cases of capital gains realized by a resident of a treaty country, both the UN and the OECD Model Conventions allocate an exclusive taxing right to that country (i.e. the country of residence of the person who realizes the gains).

In the cases where the provisions of Article 13 lead to an unlimited source taxing right, there seems to be no reason for the source country to introduce specific arrangements for the taxpayer to be able to claim specific treaty benefits, as the source country will generally be able to fully apply its domestic law[46]. This is different from the cases where the source country has a taxing right under its domestic law, but the treaty allocates an exclusive taxing right to the country of residence (like the sale of ships, boats and aircraft discussed, or shares not covered by the provisions discussed). In such cases there may be a need for arrangements to secure treaty benefits for the taxpayer. These arrangements are dealt with in section 4.5. of this paper.

3.7. Qualification issues

As described above, in several cases the treaty definitions of the various types of income refer back to domestic law, and where the domestic definition deviates between the two treaty countries, this may lead to the application by these countries of different articles of the treaty. If this is caused by the application of the domestic law, this is referred to as a conflict of qualification in the Commentaries to the OECD Model Convention.

For instance, if a parent company receives a liquidation payment due to the liquidation of its subsidiary in the other country, such payment may be treated on the basis of the domestic law of the source country as a dividend (entitling that country to levy tax on that dividend up to the percentage included in Article 10 of the treaty), whereas it may be treated as a capital gain under the domestic

[46] Assuming that a tax liability exists in these situations in that country under its domestic law, which may not always be the case.

law of the residence country (exclusively taxable in that country if not covered under a provision like Article 13, paragraph 4 of the UN and the OECD Model Conventions, or like Article 13, paragraph 5 of the UN Model Convention). Therefore, these conflicts of qualification may cause double taxation as the source country would levy the tax allowed under Article 10, whereas the country of residence would not provide relief for that tax. In the Commentary on Article 23 of the OECD Model Convention (paragraphs 31.1-32.7), the view is taken that if the conflict only arises as a consequence of applying the different domestic laws, but the source country applies the treaty correctly to that income (in the example mentioned above, by not taxing the dividends at any higher rate than that allowed under Article 10), the country of residence should then grant the relief as the source country levied the tax in accordance with the treaty[47]. It should be mentioned that conflicts of qualification have not been discussed by the UN Committee of Experts on International Cooperation in Tax Matters yet and, thus, the Commentaries to the UN Model Convention take no position with respect to this interpretative issue.

Finally, it should be mentioned that the interpretation of the OECD only applies for such conflicts arising from the application of domestic law, and not if the conflicts arise, for instance, from a different interpretation of the facts or of the treaty itself. In the latter cases, such problems can only be dealt with under the mutual agreement procedure provided under Article 25 of both the UN and the OECD Model Conventions. So, if faced with conflicts of qualification, countries not being a member of the OECD, like almost all developing countries, should consider whether such interpretation is acceptable for them when applying a tax treaty, or otherwise rely on the mutual agreement procedure to solve any relevant problems.

4. Legal framework, administrative procedures for granting treaty benefits to taxpayers, and responsible tax authorities

4.1. Approach taken: source and residence state perspective

Tax treaties are primarily concluded with the aim of avoiding double taxation and, as a result, removing obstacles for the cross border mobility of persons and investment. This is done to promote the economic development of both countries concerned. It is therefore obvious that if tax treaties

[47] On the other hand, in the reverse situation (the source country considers the capital gains article applicable, while the country of residence considers the dividends article applicable), the residence country will not be obliged to give relief, as the source country considered that it was not entitled to tax the income in accordance with the treaty.

cannot be properly applied, including the granting of the benefits to those entitled to them, the whole purpose of tax treaties may be jeopardized. On the other hand, tax treaties are also meant to prevent tax avoidance and evasion, and the tax benefits included in these treaties should only be granted to those entitled to them.

Several issues need to be dealt with in order to apply tax treaties properly. These issues depend on various aspects of the specific legal structure existing in the countries, as well as on the technical and administrative resources available to the local tax administrations, and finally on the volume of the cross border income flows, which may influence whether more sophisticated regulations and systems need to be developed, or not.

Tax treaties are virtually silent on the matter of their application and basically leave this aspect to the domestic law of the countries concerned. Only the articles on dividends, interest and royalties contain provisions on this matter[48]. These articles read as follows: "the competent authorities of the Contacting States shall by mutual agreement settle the mode of application" of the relevant provisions. However, the Commentaries on these provisions indicate that the source countries are free to apply their domestic law[49].

It has been pointed out, in international tax literature, that countries do not always make such mutual agreements in practice and that no generally accepted standardized approaches have been developed[50]. Thus, it is not possible to present a generally acceptable and universally applicable approach to deal with all the aspects of the application of tax treaties.

Therefore, the most feasible approach seems to be describing a kind of general common denominator in the practices which are normally followed by countries[51], taking also into account some recent

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48 With respect to dividends, see Article 10, paragraph 2 of both the UN and the OECD Model Conventions; with regard to interest, see Article 11, paragraph 2 of both the aforesaid Model Conventions; and with respect to royalties, see Article 12, paragraph 2 of the UN Model Convention. As the OECD Model Convention allocates an exclusive taxing right to the residence country of the recipient of royalty payments, in the case of royalties it was apparently considered not necessary to include a similar provision.

49 On this point, see Brian Arnold, Overview of Major Issues in the Application of Tax Treaties, Paper 1-A of this collection.

50 See David W. Williams, IFA General Report on "Practical issues in the application of double taxation conventions", vol. LXXXIIIb, Cahiers de droit fiscal international (Deventer, The Netherlands: Kluwer, 1998).

51 Reference is made to the practices described in David W. Williams, IFA General Report on "Practical issues in the application of double taxation conventions", vol. LXXXIIIb, Cahiers de droit fiscal international (Deventer, The Netherlands: Kluwer, 1998).

developments in this area of treaty application. Thus, the following sections are aimed at providing some further insight into the various issues concerned and making some general recommendations, taking into account the specific nature of the various types of income and gains dealt with in this paper and how taxes on these income and gains are generally levied and administered.

Although the focus in this paper is on the application of the treaty in the source country, aspects of treaty application with respect to the granting of double taxation relief in the residence country will be briefly discussed as well[52]. The more general legal and administrative aspects, including the organization of the tax administration, will be dealt with in a separate section; subsequently, a more detailed discussion of possible approaches regarding the practical application of tax treaties will follow, which will address separately the relevant issues for each type of income and gains considered in this paper.

4.2. More specific legal framework and aspects regarding the tax administration

As mentioned previously, it is of great importance that the treaty receives the binding force in the legal system of the countries concerned and, if necessary, legislation dealing with that is introduced and applicable before it becomes effective.

It is also important to assure that a sufficient legal basis exists for implementing decrees, regulations etc. (to be issued by the responsible officials) about the modalities through which treaty benefits can be enjoyed. In this respect, reference can be made to the procedures through which a rate reduction of or exemption from the withholding taxes on dividends, interest and royalties can be realized.

Furthermore, it seems important for the application of tax treaties that these implementing decrees or regulations include any statutory time limits to the possibility of applying for the benefits or reliefs provided for under the treaty. It seems equally useful that such decrees or regulations mention the (local) tax inspectors or entities dealing with the specific treaty application. To this end, it is important to take into account both the types of taxes involved and the level of knowledge available in the tax administration, as well as the frequency of treaty application in practice, which may vary considerably amongst countries, depending on the level of international investment and the number of tax treaties applicable.

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[52] For a comprehensive discussion of the aspects relating to the granting of double taxation relief in the residence country, see Peter Harris, Taxation of Residents of Foreign Source Income, Paper 3-A of this collection.

Also in the area of tax treaty application, the tax administration should have enough legal powers to be able to acquire all relevant information and obtain co-operation of the taxpayer, to be able to judge the validity of the claims for such benefits, as well the powers to properly enforce tax claims or to make additional assessments in case it turns out that the taxpayer was not entitled to the specific treaty benefits. On the other hand, it seems also important from a taxpayer perspective that any decision regarding the tax relief (at source) or refund of taxes assessed by a tax inspector can be appealed within a certain period to be determined. Albeit such aspects may have already been included in the existing tax legislation, depending on the circumstances, it may be desirable to include more specific provisions or to refer to these in the case of specific decrees or regulations regarding treaty application.

As regards the organization of the tax administration, depending on the specific circumstances in the country concerned, it will need to be determined which entity is best suitable to deal with these international matters (taking into account the type of taxes, the level of education and language skills of the various tax entities), and whether a restructuring of the current division of tasks is necessary to be able to properly apply tax treaties. For instance, decisions regarding rate reduction of the withholding tax at source can perhaps best be made by the tax inspector/inspectorate responsible for imposing such taxes, which may be the tax inspectorate responsible for the corporate income tax of the company paying the income, whereas applications for refunds of withholding taxes to non-residents may perhaps be best dealt with by a specific entity dealing with the taxation of non-residents.

Under all methods and procedures used, the entitlement to treaty benefits of specific entities (like partnerships, trusts, collective investment vehicles, pension funds and charities) may pose problems[53]. If not solved in the treaty or in interpretative mutual agreements, as provided under Article 25 of both the UN and the OECD Model Conventions, these issues will need to be discussed with the competent tax authorities on an ad hoc basis. If solved, such interpretation should be published and included in the relevant decrees, regulations, instructions to forms used etc. for treaty application.

More detailed remarks on treaty application and enforcement will be made hereafter, separately for each specific category of investment income and capital gains.

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[53] See Joanna Wheeler, Persons Qualifying for Treaty Benefits, Paper 2-A of this collection.

4.3. Income from immovable property

In many countries, tax on income from immovable property is levied by way of (self-) assessment[54].and tax treaties generally allocate the taxing right over income from immovable property to the country where the property is located without any limitation[55]. Therefore, generally it may be not necessary to make any specific arrangement for granting treaty benefits to non-residents in the country where the immovable property is situated.

The main issue seems to be how to find out that a property is owned by a non-resident and whether or not the non-resident earned any income from exploiting it. In this respect, it is important whether a public register exists or not, in which the ownership of immovable property needs to be registered. Furthermore, it is critical the availability of such information to the tax administration, in addition to any specific fiscal intelligence measure (such as, searching and reporting on advertisements in which the immovable property is offered for rent, which may be difficult if the property is rented out to another non-resident).

With respect to the tax inspector or tax administration entity responsible for such taxation, in case of non-residents a special entity is often designated to deal with these taxpayers.

However, some countries do levy a withholding tax on the gross amount of (cross-border) rental income from immovable property[56]. In such case, the payer of the rent is required to withhold the tax and pass it on to the designated tax authorities.

As mentioned above, the taxing right regarding income from immovable property is generally allocated to the source country without limitation and, thus, there are generally no treaty benefits available to the non-resident recipient of the rent, for which special arrangements need to be made. Obviously, enforcement of a withholding tax may be difficult, or even impossible, when the rental income is paid to the owner by a person who is not a resident of the country where the immovable property is located. However, once the existence of income from immovable property located in a country is known, that property may provide recourse to the tax administration to collect the taxes due if not duly paid.

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54 For instance, this income may be taxable on a net income basis (which requires the taxpayer to be able to demonstrate which costs were incurred), or on an imputed income basis (e.g., in case of owner occupied holiday homes, in which case there is no cash flow on which a withholding tax could be levied).

55 See section 3.2 above.

56 In some cases, this is also combined with an option for the taxpayer to opt for taxation on a net income basis via assessment.

As regards the reverse situation of residents deriving income from immovable property located in a different country, generally Article 23[57] of the applicable treaty includes the obligation for the country of residence to provide relief from double taxation on the relevant income.

In the case of taxation by assessment by the tax authorities, it seems useful to include a requirement for the taxpayer to explicitly mention in the tax return whether relief for double taxation is claimed. Also in the case of self-assessment, it would be desirable to avail of such information, as the tax authorities are then aware that such relief has been claimed and, thus, may decide to check whether the taxpayer is indeed entitled to such relief or not.

4.4. Dividends, interest and royalties

Aspects of tax treaty application regarding these items of income will be dealt with jointly, as most countries impose a withholding tax on the gross amount of these payments made to non-residents. The so-called withholding agent is responsible for withholding the correct amount of tax. Such a system is of course attractive for the tax authorities from a perspective of both tax technical simplicity and effective enforcement.

Due to the allocation of taxing rights with respect to these types of income under tax treaties[58] , the country of source is usually only allowed to tax the income up to a certain percentage of its gross amount. In case the domestic source tax exceeds the level of tax allowed under the treaty, arrangements need to be made to provide for any reduction or exemption of source country taxation, as may be required.

Although, as mentioned above, there are no generally accepted standard procedures for providing treaty benefits, in the case of cross border payments of dividends, interest and royalties, source countries generally apply either a system of refund or a system of reduction of the withholding tax at source to grant the benefits to a resident of the other treaty country, who is the beneficial owner of the income.

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[57] See Article 23 of both the UN and the OECD Model Conventions, which deals with methods for the elimination of double taxation. Double taxation relief may be given either by way of exemption of the income, or by way of credit of any foreign taxes levied in the other country on that income. On these aspects, see Peter Harris, Taxation of Residents of Foreign Source Income, Paper 3-A of this collection.

[58] See sections 3.3-3.5.

4.4.1 Refund Method

In the case of the refund method, tax is withheld according to the domestic law of the source country, and subsequently the non-resident beneficial owner can file a request for refund with the designated tax authorities[59], in case the amount withheld exceeds the amount due according to the tax treaty. So, if 30% withholding tax was levied on the gross amount of the payment of income under domestic law, and the tax treaty allocated only a right to levy 10% tax on the gross amount of the payment, the refund would amount to 20%. In the case of portfolio investments, like securities, such requests are often made on behalf of the taxpayer by financial intermediaries, like banks. Of course, this intermediaries must be able to show proof of authorization to act on behalf of the taxpayer, for instance by a statement signed by the taxpayer.

In the countries where such requests are frequently made, the requests for refund is generally made via a form[60], which is specifically designed for each category of income, and through which relevant information needs to be provided. The forms may be either in paper or electronic format.

Generally, the information to be provided will include at least the following elements:

- Name, address, tax identification number and bank account of the recipient;
- The amount of income and the date at which it was received, as well as proof of the amount of tax withheld;
- In case the tax treaty provisions distinguish various types of dividends, interest and royalties to which different treaty rates apply, a statement indicating which category of income and which percentage of tax is considered applicable;
- In case it is relevant for the identification of the withholding tax rate applicable to dividends, information about the percentage of share capital held; and
- A statement by the tax authorities of the country of residence of the recipient confirming that the person is a resident of that country (referred to as certificate of residence).

Furthermore, specific additional requirements may apply, like a statement by the recipient that he/she is the beneficial owner of the income, or other requirements in the case of specific anti-avoidance provisions[61].

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[59] Often, this is the inspectorate who is competent for the withholding agent, or a special entity dealing with non-resident taxpayers.

[60] Generally, accompanying instructions to the form are provided, in which also the statutory deadline for application can be mentioned.

Besides the certificate of residence, also confirmation of having met other requirements may be requested from the country of residence of the recipient, but as that puts an additional burden on these other tax authorities, it seems very important that such forms or procedures are agreed upon between the relevant competent authorities of the treaty countries. In order to avoid fraud with such forms, it may be agreed between the treaty countries that the forms duly certified by the competent authorities of the country of residence of the recipient will be sent directly to the competent authorities of the source country.

It seems advisable for the tax authorities to regulate this procedure and related forms via decree or other regulations, which may then be published, for instance, in the state bulletin of the country. Some countries agree in a mutual agreement with the competent authority of the other country to exchange (a summary of) the procedures, which could also be published in the other country, for the benefit of its taxpayers.

The decision for refund could be taken by a formal decision entitling the taxpayer to file an appeal against it.

Obviously, a refund procedure is attractive for the source country from a budgetary perspective, as the country keeps the tax withheld until the application has been received and verified and the refund has been made. However, it is not attractive for the foreign investors, as initially they only receive the payments as reduced by the full withholding applicable under the domestic law of the source country. This is especially burdensome if the refund is not made within a reasonable time.

4.4.2 Reduction at Source Method

In order to improve the attractiveness of a country for foreign investment, the method of reduction of taxation at source is increasingly used, while the refund method is still available in case the formalities could not be finalized and communicated to the withholding agent before the time of the payment of the income.

Generally speaking, this method equally works with paper or electronic application forms containing similar requirements as the ones mentioned above for the case of refund, including the certification of the residency of the recipient by the competent authorities of the country of residence. After filing the applications, and verification and approval by the designated tax authorities of the source

[61] See Joanna Wheeler, Persons Qualifying for Treaty Benefits, Papers 2-A of this collection.

country[62], the (appealable) decision is sent by the tax authorities of this country to the taxpayer or directly to the withholding agent, who is then allowed to immediately apply the limitation imposed by the treaty and to withhold the reduced amount of tax on the payments made.

Obviously, if the procedure is started at a late stage, or if the authorities involved cannot deal with the requests timely enough, the withholding agent may not be able to apply the reduction at the time of payment, and then the refund method needs to be applied.

Usually, a separate form needs to be filed for each payment; however, for efficiency reasons, it is increasingly agreed between the competent tax authorities, especially in case of regular payments, like on loans, licenses or shareholdings which last several years, that the certificate of residence and the approval are valid for a number of years. In such cases, however, the taxpayer must immediately give notice to the relevant tax authorities concerned if the circumstances have changed.

In some countries, withholding agents can themselves decide to directly apply the reduced tax treaty rate if they consider that the taxpayer has sufficiently demonstrated that she/he is entitled to such benefits. Withholding agents may, however, be reluctant to do that, as in case it turns out that the non-resident taxpayer was not entitled to the treaty benefits, the withholding agent may be held liable to pay the additional tax due, as well as fines to the tax authorities.

Finally, in case the source state is allocated a right to levy a tax on the dividends, interest and royalties, the country of residence will have to provide relief for the avoidance of double taxation, in accordance with Article 23 of both the UN and the OECD Model Conventions[63].

4.4.3 Treaty Relief and Compliance Enhancement (TRACE)

It may have become clear from the methods described above that these may be quite burdensome to operate, both for taxpayers and tax authorities, and may create a serious obstacle for taxpayers to receive the treaty benefits.

On 11 February 2013 the OECD published a "Treaty Relief and Compliance Enhancement (TRACE) — Implementation Package"[64], which deals with the application of treaty benefits with respect to

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62 In this case, probably the inspectorate competent for the activities of the withholding agent.

63 Double taxation relief may be given either by way of exemption of the income, or by way of credit of any foreign taxes levied in the other country on that income. On these aspects, see Peter Harris, Taxation of Residents of Foreign Source Income, Paper 3-A of this collection.

dividends and interests on securities held via financial intermediaries. Despite the fact that TRACE may be too expensive and too complicated for the purposes of many developing countries, it is interesting to mention some of the main features of this system as it addresses several of the topics discussed above and contains some forms based on best practices, which — in an amended form — might still be useful for developing countries. The system is aimed at making the process of obtaining the treaty benefits of reduced withholding taxes on dividends and interest as efficient as possible, on the one hand, by minimizing administrative efforts and costs and, on the other hand, by enhancing countries abilities to ensure proper compliance with tax obligations.

Some of the main features of the system may be summarized as follows:

- Authorized intermediaries[65] would be allowed to claim exemptions or reduced rates of withholding tax on a annual "pooled basis" on behalf of their portfolio investors (the Package includes standard applications for granting that status and model contracts between such intermediaries and the source country, including agreed procedures and rules on the extent of the intermediaries liability for under withholding, and it also provides for a review of the compliance of the intermediaries by independent reviewers);
- The claims will be supported by standardized investor self-declarations (in principle valid for 5 years) containing all relevant information, like identification via name, address details and taxpayer identification numbers of the beneficial owner, and in case of entities the type of entity, as well as statements of residence and beneficial ownership of the income, as well as specification of the types of income and exemptions or reduced rates claimed. Standard self-declaration forms for both individuals and entities are included in the Package[66];
- The source country will subsequently exchange the information on an automatic basis with the tax authorities of the country of residence of the investors, which will make the necessary verifications and inform the source country if certain taxpayers are not entitled to the treaty benefits[67].

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64 Available at http://www.oecd.org/tax/exchange-of-tax-information/treatyreliefandcomplianceenhancementtrace.htm.

65 Like financial institutions, collective investment vehicles, and custodians, as well as their approved affiliates.

66 To access these forms, see footnote 64.

67 It is recommended that states agree on the timing and modalities via specific memorandum of understanding (MOU).

Generally, this procedure might not be available in case of specific investor entities, like partnerships, collective investment vehicles etc., until their treatment[68] has been clarified by the tax authorities. Furthermore, it is recognized that specific domestic legislation may be needed to enable elements of the package to be implemented, or to clarify certain aspects.

4.5. Capital gains

As discussed above in sections 2.2. and 3.6, there are many differences in the taxation of capital gains in the various countries and, depending on the nature of the assets, different allocation rules in tax treaties.

In the case of Article 13, paragraphs 1 and 2[69], of both the UN and the OECD Model Conventions, the source country has the full taxing right over the gains and; thus, there is no entitlement to reduction of the taxation in the source country on the basis of the tax treaty and, hence, no need for specific administrative procedures for claiming treaty benefits.

In the case of Article 13, paragraph 3, of both the aforesaid Model Conventions, an exclusive taxing right over gains from the alienation of ships and aircraft operated in international traffic and boats engaged in inland waterway transport is granted to the country in which the place of effective management of the enterprise is situated. Even if a source country could tax such gains under its domestic law, it should refrain from taxing these gains if the place of effective management is in the other country. The tax on the profits of an enterprise is usually levied by assessment. In the case of self-assessment and assessment by the tax authorities, and assuming that there is no other taxable income in the source country, the taxpayer might not be required to file a nil assessment or a tax return, as no tax is due according to the tax treaty. In case non-resident tax liability exists under domestic law, the question will arise as whether the domestic law requires the non-resident to report the income and file a nil assessment or a tax return to claim the treaty benefit. This will depend on the relevant provisions in the domestic law of the country[70].

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68 As to whether they can claim benefits themselves, or whether only the underlying participants in such entities can do so.

69 These paragraphs deal with gains on immovable property located in the source country, and gains on the alienation of movable property of a permanent establishment situated in the source country, respectively.

70 The advantage of having such obligation is that the tax authorities can check whether the treaty benefit was justified. On the other hand, it would impose administrative obligations in cases where no tax may be due.

As regards Article 13, paragraph 4, of both the UN and the OECD Model Conventions, the situation is similar to the one dealt with under paragraphs 1 and 2 of this Article, as also the source country, under the treaty, is allowed to fully tax the gains on the alienation of shares if all the conditions provided under the treaty provisions are met. In such case, the taxpayer will have to file a self-assessment or a tax return, provided that the gains are also taxable under domestic tax law. Thus, as there are no treaty benefits to be claimed, it doesn't seem necessary introducing any further specific administrative arrangements for claiming these benefits.

The real challenge for tax administrations of the source country is to discover the taxable gain in case the non-resident seller has not reported the income. This would be a matter of fiscal intelligence. In the case of a register in which the ownership of shares must be entered or of a domestic resident buyer, the change of ownership in the register or the bookkeeping of the buyer, respectively, may point the tax administration at the non-resident's tax liability. If, however, the shares in the company or entity holding the immovable property have not been alienated, but rather the shares in a company which in turn owns, directly or indirectly, the company owning the immovable property, it may become very difficult to enforce a domestic tax liability[71].

In case of Article 13, paragraph 5, of the UN Model Convention[72], the situation seems to be similar for the source country to that under Article 13, paragraph 4, of both the UN and the OECD Model Conventions. In this case, a taxing right is allocated by the treaty to the source country and, thus, there is no need to make arrangements for treaty benefits to be granted in the source country. In case, under the domestic law, the non-resident seller is liable to tax, the problem will be again how to enforce such taxation if the gain is not reported by the taxpayer.

If the source country imposes a tax liability on the sale of shares by a resident of the other treaty country, which is not covered under Article 13, paragraph 2 or 4, of both the aforesaid Model Conventions (and neither by Article 13, paragraph 5, in the case of a treaty following the UN Model Convention), and the treaty allocates the exclusive taxing right on such gain to the country of residence[73], then a treaty benefit needs to be granted by the source country. As taxes on such gains are usually levied by assessment, the claim for such exemption from tax in the source country could

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71 If existing at all for such case of indirect sale of shares or participations in other entities.

72 This provision deals with the sale of shares in a company that is resident in the source country by a seller who is a resident of the other treaty country, and who owned a substantial participation in that company during a certain period of time.

73 Article 13, paragraph 5, of the OECD Model Convention and Article 13, paragraph 6, of the UN Model Convention.

be made either when filing a tax return under a self-assessment system or when information is provided to the tax authorities under a system of assessment by the tax authorities. Also in this case, it is a matter of domestic law whether or not such filing needs to take place and whether such gains must be reported and an exemption claimed on the basis of the tax treaty, or only the taxable income must be reported after applying the treaty benefit[74].

In view of the problems of enforcing taxation on capital gains on the sale of shares, and especially in the case of indirect sales of shares when the domestic law and the treaty allow for that, some countries have introduced reporting requirements, or even an obligation on the buyer to withhold tax on the gross amount of the purchase price, in their domestic law.

In case domestic tax liability on the sale of shares goes beyond what is allowed under an applicable tax treaty, arrangements will need to be made for the non-resident seller to enjoy treaty benefits. For instance, in the case of the above-mentioned withholding obligation on the buyer, this could be done by a provision in the law of the source country, which allows the buyer to refrain from withholding the tax subject to consent of the competent tax authority. Depending on the organization of the tax administration, that competent tax authority may be the tax inspector responsible for the area where the buyer resides or, in the special case of a non-resident buyer, a special entity of the tax administration which is responsible for the taxation of non-residents.

Finally, in case the source country is allocated a right to levy a tax under Article 13 of both the UN and the OECD Model Conventions, the country of residence, in accordance with Article 23 of both these Model Conventions, will have to provide relief for the avoidance of double taxation[75].

5. Enforcement

5.1. General aspects

In this section, the following aspects regarding enforcement will be discussed:

- Legislative aspects;

[74] In the latter case, the tax administration would have no indication that the treaty entitlement may need to be checked. On the other hand, administrative burdens would be avoided in cases where generally no tax is due.

[75] This can be done by either the exemption method, or the credit method. On these aspects, see Peter Harris, Taxation of Residents of Foreign Source Income, Paper 3-A of this collection.

- Avaibility of information;
- Organization of the tax administration applying the domestic law and tax treaties, and
- Collection of the taxes.

Only a selected number of these aspects will be analyzed, with specific respect to the types of income and gains covered in this paper. Aspects regarding domestic law and aspects regarding international law will be dealt with separately. In the context of international law aspects, some attention will also be paid to the so called "FATCA legislation" of the United States[76], as it may have an impact on financial institutions and tax authorities of developing countries.

5.2. Aspects of domestic law

With respect to the domestic legal framework, several aspects may be important for the enforcement of taxation of the different types of income and gains dealt with in this paper.

The following aspects regarding legislative issues can be considered:

- Is the legal basis to apply tax treaties sufficient (including both the application of substantive tax provisions and of formal provisions, such as, for instance, in case of international exchange of information and assistance in the collection of taxes)?
- Have implementing decrees, regulations, or forms (with accompanying instructions, including, for instance, information about statutory deadlines) been issued to clarify the procedures to apply for claiming treaty benefits?
- Is the notion of immovable property properly defined in domestic law and is there clarity regarding immovable rights?
- Can indirect sales of immovable property, as dealt with under Article 13, paragraph 4, of both the UN and the OECD Model Conventions, be taxed under domestic law?
- Is there a legal obligation to register ownership of immovable property in public registers?
- Is there an adequate definition of dividends, also taking into account hybrid financing and excessive payments of interest and of royalties in related party situations?

[76] The Foreign Account Tax Compliance Act (FATCA) is aimed at enforcing US tax liability on US taxpayers, who hold unreported accounts via foreign financial institutions.

- Is there an adequate transfer pricing legislation in place to determine what constitutes excessive payments between related parties?
- Is the notion of interest properly defined and are there anti-abuse rules in the area of thin capitalization and is re-qualification of interest possible under these rules?
- Is there a clear notion of royalties, clarifying the differences between rights to use and (partial) alienation? Is the situation regarding payments for software clear? Is there a clear distinction between royalties and technical services?
- Is there an obligation to register the ownership of shares in companies?
- In case of sale of shares in resident companies, is there a source rule/tax liability in the domestic law as provided under Article 13, paragraph 5, of the UN Model Convention?
- Is there general anti-abuse legislation or an anti-abuse doctrine developed in case law?
- Are there sufficient powers for the tax administration to do audits, acquire information, including from banks?
- Is the statute of limitations adequate in international situations, where it may take more time before information becomes available?
- Can decisions be appealed by taxpayers to independent tax courts to secure proper enforcement?
- Should certain taxes be imposed via (self-) assessment or via a withholding tax system?
- Should certain reporting requirements be introduced to discover taxable events or to be able to judge whether treaty application by the taxpayer was correct?

As regards information, the following points may deserve attention (besides the points regarding information already listed above):

- Is information available and used regarding ownership of immovable property situated in the country?
- Is information available regarding payments of dividends, interest and royalties and is it used?
- Is tax technical information on international tax issues (including texts of tax treaties concluded, case law, literature) available within the tax administration for persons involved in these matters?

- Can international assistance regarding information be effectively used?
- Is there sufficient fiscal intelligence to gather relevant information regarding the various types of income (for instance to find out whether shares have been alienated by non-resident owners)?

With respect to the organization of the tax administration, the following points may be relevant in this context:

- Is there enough international tax expertise in the units dealing with international tax aspects?
- Are there enough resources available to apply tax treaties?
- Should certain international tax aspects be dealt with by local units or by specialized units (e.g. non-residents taxation by assessment, decisions to allow withholding agents to provide tax treaty benefits at source)?
- Are there sufficient language skills in the units dealing with international tax matters?
- Is there a separate fiscal intelligence unit gathering and distributing relevant tax information on international tax matters?

As regards the collection of taxes, the following points may deserve attention:

- Are withholding tax systems adequately applied?
- Can international situations be properly handled?
- Can international assistance in collection be provided or requested?
- Can refunds be managed properly and are there incentives to grant these refunds within acceptable time limits?

5.3. Aspects of international law

With respect to the international legal framework, the following aspects may be important for the enforcement of taxation of the different types of income and gains dealt with in this paper:

- Do tax treaties allocate taxing rights to a country which cannot be enforced by that country?
- Do the tax treaties or administrative co-operation treaties contain adequate provisions on the exchange of information?

- Do tax treaties or administrative co-operation agreements contain adequate provisions regarding assistance in the collection of taxes?
- Do tax treaties contain adequate anti-abuse provisions to secure the proper application of the tax treaty and enforcement of the relevant taxes?

5.4. Foreign Account Tax Compliance Act (FATCA)

Finally, albeit primarily focused on combating tax evasion by United State (US) taxpayers, it seems useful to briefly mention the Foreign Account Tax Compliance Act (FATCA) of the US, which can also be applicable in relation to financial institutions in developing countries with US account holders.

This legislation is aimed at combating tax evasion by US taxpayers via the use of accounts (depository or custodian accounts) kept at Foreign Financial Institutions (FFIs), or any equity or debt in such Financial Institution, or via certain Non Financial Foreign Entities NFFIs). This legislation imposes, amongst other, reporting requirements on FFIs and NFFI's. For instance, FFIs should report to the US Internal Revenue Service (IRS) any US and foreign source income of US taxpayers enjoyed directly by them via the FFI or via US owned foreign entities, and in that context review all accounts maintained by the FFI and its affiliated group, as well as look through foreign shell companies and determine whether US taxpayers are the beneficial owners of the income. They should also withhold and pay over to the IRS 30% of any pass through payment by the FFI to non-participating FFIs or to recalcitrant account holders. Non-compliant or non-participating FFIs will face a 30% withholding tax on any payments to them of dividends, interest and royalties and other periodic payments from US sources, and of gross proceeds from the sale of disposition of property that can produce US source interest or dividends. To address foreign local law impediments to comply with FATCA, simplify practical implementation and reduce costs for Foreign FFIs, intergovernmental agreements have been concluded or are being concluded by the US with 50 jurisdictions, based on model Inter Governmental Agreements (IGAs), under which the FFI's provide certain agreed information to the tax authorities in their own country, which these authorities would then pass on to the IRS via exchange of information.

One of the two model IGAs provides for reciprocity of obligations, thus obliging the USA to provide such information to residents of the other country.

Although the focus of FATCA is different from the aim of tax treaties, that is to provide treaty benefits to own residents (relief from double taxation) or to residents of another country (reduction of source taxation) entitled to such benefits, there might be certain points of contact with tax treaty application, for instance in the area of documentation requirements, forms etc. The TRACE Group, which developed the TRACE system discussed above, will also be working on ensuring that the reporting requirements under TRACE are aligned to those of other reporting regimes, like FATCA, in order to reduce implementation costs for all stakeholders involved.