Overview of the Application of Bilateral Tax Treaties

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Introduction

- Overview of issues covered in UN Handbook on Administration of Double Tax Treaties

- Purpose of overview:
  - Some background
  - Description of the topic
  - Identification of the issues

- Focus on developing countries/source countries
Topic

- Administration or practical application of tax treaties
- Comes after negotiation of treaty
- Involves procedural issues: how does country provide the benefits of its tax treaties?
- Involves interpretation – what does the treaty mean?
- But interpretative issues are not our primary focus

Outline of Overview

1) Relationship between tax treaties and domestic law
2) Application rules in domestic law
3) Application rules in tax treaties
4) Application of tax treaties to residents
Outline of Overview

5) Application of tax treaties to nonresidents
   – In general
   – Nonresidents earning business profits
   – Nonresidents performing services
   – Nonresidents earning investment income and capital gains

6) Tax treaties and tax avoidance

Relationship between Tax Treaties and Domestic Law

- May have important consequences for the application of tax treaties
- Varies widely from country to country
- In some countries, treaties are self-executing
- In other countries, treaties must be incorporated into domestic law
Relationship between Tax Treaties and Domestic Law

- Tax treaties generally have priority over domestic law in the event of a conflict
- This priority may be a constitutional, statutory or judicial requirement
- Can domestic law override a tax treaty?
  - E.g., domestic anti-avoidance rules
  - Possible in some countries, but not in others

Application Rules in Tax Treaties

- Very few application rules in UN and OECD Models
- Commentary indicates how provisions of treaty are applied is a matter for domestic law
- Paragraph 13, Commentary on Article 10; Paragraph 18 of Commentary on Article 11
Application Rules in Tax Treaties

- Articles 10(2), 11(2) and 12(2):
  “The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations”
- Seldom used
- Country is free to require withholding at treaty rate or at domestic rate and require nonresidents to apply for refund
- OECD Commentary expresses preference for withholding at treaty rate

Other Treaty Application Rules

- Article 24 – Nondiscrimination
  - Article 24(1), (2) and (5) apply to “connected requirements”
  - Commentary indicates that additional information requirements and reversed burden of proof on domestic enterprises owned or controlled by nonresidents is not discriminatory
  - Article 24(3) and (4) do not extend to connected requirements
Other Treaty Application Rules

- Article 23 (Commentary) – application rules must be found in domestic law
- Article 25 – Mutual Agreement Procedure
- Article 26 – Exchange of Information
- Article 27 – Assistance in Collection of Tax

Application Rules in Domestic Law

- Important because such rules are not provided in tax treaties
- Often overshadowed by negotiating concerns
- Countries have considerable freedom
- Counties should consider seriously what rules are necessary in their domestic law
Application Rules in Domestic Law

- General rules for all treaties or different rules for different treaties
- Legislative or administrative rules
- Relationship with method of assessment under domestic law
  - Self-assessment
  - Assessment by the tax authorities
  - Withholding
- Role and powers of the tax authorities in the application of tax treaties

Most countries apply general domestic procedural rules to the application of tax treaties

Special treaty rules tend to be the result of ad hoc responses to problems

Worthwhile to consider:
- Tax returns and other forms
- Information disclosure
- Time limits
- Burden of proof
Method of Assessment of Nonresidents

- Most countries use withholding for certain income (investment income) and assessment for business profits
- Under self-assessment, taxpayer applies treaty in first instance
  - Require tax return even if exempt
  - Require disclosure of treaty claim
- Under assessment by tax authorities, tax authorities apply treaty
  - Require taxpayer to make request for treaty benefit and provide information

Withholding

- Interim withholding often used for employees or service providers and sometimes for capital gains
- Final withholding used for dividends, interest, royalties
- Obligation to withhold imposed on resident payer (or nonresident with a PE or fixed base)
- Rate of withholding?
  - Treaty rate or higher domestic rate followed by refund
  - If former, withholding agent applies the treaty initially
- Need to balance delivery of treaty benefits on a timely basis and verification of treaty claims
Role of the Tax Authorities

➢ Where is responsibility for administering tax treaties located in the tax administration?
  – Centralized unit or decentralized
  – International unit
  – Separate unit for nonresidents

➢ Development of expertise concerning tax treaties

Role of the Tax Authorities

➢ Tax authorities must have the necessary powers under domestic law to investigate claims, get information and collect tax

➢ Tax authorities should provide information to taxpayers
  – Text of treaties
  – Forms
  – Information required
  – Time limits

➢ Possibility of binding rulings or informal guidance
Persons Entitled to Treaty Benefits

- **Residence determinations**
  - “person”: relatively easy to determine
  - “resident” for Articles 23, 24(4) and (5):
    - Easy to determine as country applies its own domestic law
  - “resident” for most articles: determined under law of the other state
    - Resident certificates

- **Dual residents**
- **Hybrid entities**

Beneficial Owner

- **Requirement for Articles 10, 11 and 12**
- **Many issues and much uncertainty**
  - International fiscal meaning or meaning under domestic law?
  - OECD Commentary (revised in 2014) indicates term has an international fiscal meaning
  - Broad anti-avoidance rule or limited to agents, nominees and pure conduits?
Application of Tax Treaties to a Country’s Own Residents

- Important primarily for relief from double taxation and nondiscrimination under Article 24(4) and (5)
- Article 23 relief by way of exemption or foreign tax credit
  - Most countries use both methods
- Details for application supplied by domestic law because Article 23 is broad and general

Article 23 – Issues

- General problem if treaty provides relief that is not provided under domestic law
- Exemption method
  - Residence country needs information about amount of income earned in the source country
  - Possibility of double non-taxation
  - Treatment of losses
Article 23 – Issues

➢ Credit method
  – Timing of income, foreign exchange, limitation, losses
  – Need proof as to foreign tax paid and information about foreign income
  – Tax sparing provisions

Application of Tax Treaties to Nonresidents

1) Identify nonresidents subject to domestic tax
2) Gather information
3) Determine whether nonresident qualifies for treaty benefits
4) Determine the reduction in source country tax and the manner of delivery
5) Collecting the tax
Nonresidents Earning Business Profits

Once it has been determined that taxpayer is entitled to benefits of particular treaty, it must be determined which article applies

Possibilities:
- Article 6 – immovable property
- Article 7 – business profits
- Article 8 – international shipping and air transport
- Article 14 – professional and independent services
- Article 17 – entertainment and sports activities
- Article 21 – other income

Issues under Article 7

- Identify nonresidents carrying on business in the source country
- Determine the country in which the taxpayer is resident
- Threshold: is business carried on through a PE?
  - Intensely factual
  - Requires good information
- Does another article apply? – see Article 7(6)
- Determination of profits attributable to PE
  - Computation of income under domestic law
  - Net income – Articles 7(3) and 24(3)
  - Attributable income under treaty
Issues under Article 17

- **Threshold:** do entertainment or sports activities occur in the source country?
  - Requires good and timely intelligence
  - Need to distinguish between Article 17 and other activities

- **Determination of income**
  - Matter for domestic law
  - Net or gross
  - Usually collected by withholding on gross
  - Avoidance through diversion of income to another person – Article 17(2)

Income from Services

- **Same steps as for nonresidents generally**
- **Which article applies?** – for example, Article 15 (employment) or Article 7 or 14 (professional or independent services)
  - Consequences are very important
- **Is threshold for source country tax met?**
  - Services performed in source country
  - PE, fixed base or time period

- **Determination of income and imposition of tax**
  - Problems with withholding (waivers)
Investment Income

- Same steps as for nonresidents generally
- Which article applies? – depends on character of payment
- Beneficial owner requirement for Articles 10, 11 and 12
- Most countries use final withholding so that withholding agent is responsible for determining treaty benefits
- Article 13 (capital gains) presents special difficulties

Tax Avoidance and Tax Treaties

- Topic is covered in detail in Commentary on Article 1
- Do tax treaties prevent the application of domestic anti-avoidance rules?
  - The subsequent Commentary issue
- Anti-avoidance rules in tax treaties
- Commentary cautions about exclusive reliance on specific rules
- Interpretation of tax treaties to prevent abuse
Tax Avoidance and Tax Treaties

- The guiding principle:

  "A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."

- Important to balance need to prevent abuse and respect for treaty obligations

Conclusion

- The relationship between tax treaties and domestic law is intimate and requires careful consideration
- Consider administrative issues before entering into treaties
- The need for expertise concerning the interpretation and application of tax treaties is important
Thank you

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