Application of Treaties to Residents

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UN-ITC Workshop on Administration of Tax Treaties and Addressing Base-Eroding Payments
Berlin 1-3 December 2015

General

- In general, treaties have little impact on the taxation of residents by the residence country
  - Primary treaty focus is on limits on source country taxation of nonresidents
  - Use of “saving” clause by some countries makes explicit that restrictions on resident taxation are limited
- Article 23 requires residence country to relieve double taxation

General

- Treaty rules on double tax relief in Article 23 are very general and leave details to domestic law
- Some treaties make specific reference to domestic law on double tax relief in Article 23
- Basic approach is in general terms to require either an "exemption" method (Art. 23 A) or a "credit" method (Art. 23 B)
- Double tax relief must only be given by the residence state for income which under the treaty distributive rules "may be taxed" in the other state.

Steps in Applying Article 23

1) Does the domestic law of the residence country in general tax foreign income?

2) Does the domestic law of the residence country tax foreign income of this type?

3) If it does tax the income, is there a mechanism in domestic law for giving double tax relief either by exemption or credit?

4) Is the treaty partner taxing the income "in accordance with the treaty?"

Basic features of an exemption system

- **Exemption systems typically only give exemption for certain types of income, e.g., income attributable to a permanent establishment located in the source country**
  - Amount to be exempted is determined under residence country law. Commentary on Article 23, para 16
  - Source state must be taxing "in accordance with the treaty"
  - Classification issues

Basic features of an exemption system

- **For income which is not exempt under domestic law and which falls under Articles 10, 11, 12 and 13, Article 23 A (2) requires that the residence state give a credit for the source country tax appropriately imposed on the item of income.**
- **Where the source country is given a right to tax the income but does not exercise it, the exemption country may wish to apply the credit method to avoid the problem of double non-taxation. UN Commentary, Art. 23, para 15**

Basic features of an exemption system

- **The residence state may take the exempt income into account in calculating the amount of tax due on other income ("exemption with progression"), Article 23A (3)**
  - Various ways of calculating the impact of the exemption
- **Consideration of the effect of foreign losses on the computation of tax on domestic income where foreign income would have been exempt**
  - Country practices vary

Basic features of a credit system

- **The foreign source income is initially included in full in the residence country tax base, with its character and amount determined under domestic tax rules**
  - Allocation of expenses
  - Treatment of losses
- **The amount of the creditable foreign tax is calculated by first determining the amount of income which may be taxed by the source country under the treaty distributive rules**
  - Classification issues
- **The foreign tax which qualifies for the credit and is attributable to the qualifying income is credited ("a deduction from the tax") against the domestic tax liability as initially determined**
- **Possibility of carrying unused foreign tax credits forward to use in other years.**

Basic features of a credit system

- There are typically limits on the amount of foreign tax which can be credited against the domestic tax liability currently.
- Basic limit is based on the amount of domestic tax paid on the income: "ordinary credit"
- No credit for foreign taxes in excess of domestic tax on foreign income; foreign tax credits cannot reduce tax on domestic source income
- Various other forms of limitation on the credit possible and much variety in domestic systems

"Ordinary" Credit

Example 1: Company R of Country R has income from Country S of 100 which Country S is entitled to tax at 40% and also has income of 100 from Country R. The domestic tax rate in Country R is 30%

- Tentative Country R tax liability: 30x(100+100)=60
- "Ordinary" Credit: Limited to 30, the Country R tax on the income which Country S is entitled to tax under the treaty
- Total tax payable by Company R: 40 +30
- Double taxation has been relieved and no credit has been allowed for the higher Country S tax against the Country R domestic source income

Limitations on the foreign tax credit: Per item limitation

- **“Per item” limitation: only credit for the foreign tax on a particular item of income**

Example 2: Company R of Country R has 100 of business profits from Country S taxable at 40% and 100 of royalties from Country S taxable at 20%. The tax rate in Country R is 30%.

- Tentative Country R tax: 30x(100+100)=60
- Foreign tax credit on the business profits: limited to 30
- Foreign tax credit on the royalties: 20, additional Country R tax on the royalties, 10
- Total tax: 70
- No averaging of foreign taxes on business profits and royalties.

Limitations on the foreign tax credit: Per Country Limitation

Example 3: Company R of Country R has 100 of business profits from Country S taxable at 40% and 100 of business profits from Country T taxable at 20%. The tax rate in Country R is 30%.

- Tentative Country R tax: 30x(100+100)=60
- Foreign tax credit on the business profits from Country S: limited to 30
- Foreign tax credit on the business profits from Country T: 20, additional Country R tax on the business profits, 10
- Total tax: 70
- No averaging between the business profits from Country S and Country T

Comparison of exemption and credit systems

- **In a credit system, the effective rate of tax on the applicable foreign source income is determined by the higher of the domestic rate or the foreign rate**
  - Capital export neutrality
- **A credit system with an overall limitation is relatively simple BUT may allow inappropriate averaging, creation of passive foreign source income, etc.**
- **Other limitations can vary in complexity**
- **A credit system can eliminate the advantages of a source country tax holiday: good or bad?**
- **Tax sparing**

Exemption v Credit Effects

Example 4: Company R of Country R has 100 of business profits from Country S taxed at 20%. The tax rate in Country R is 30%.

- If Country R has an exemption system as described in Article 23 A and the income qualifies for the exemption, there would be no additional Country R tax liability. However, the exempt income might affect the rate of tax on other income (“exemption with progression”)
- If Country R had a credit system as described in Article 23 B, there would be a credit of 20 for the Country S tax and 10 of additional tax in Country R
- It the tax rate in Country S was 40%, there would be no change under an exemption system. If Country R had a credit system, all of the Country R tax would be eliminated by a credit of 30 and the result would be the same as under an exemption system

Limitations on the foreign tax credit: Overall limitation

- **In an overall limitation, there is no restriction on averaging and the only limit on the credit is the Country R tax on the total foreign income under the "ordinary credit" approach**

Example 5: Company R of Country R has 100 of income from Country S which is not taxed, 100 from Country T which is taxed at 40% and 100 from Country U which is taxed at 50%. The tax rate in Country R is 30%

– Tentative Country R tax: 90

– Foreign tax credit for Country T and Country U taxes: 90; therefore, no residual Country R tax

– The 100 of untaxed income from Country S allowed a credit for the taxes paid to Countries T and U at rates in excess of the Country R rate

Administrative aspects of exemption and credit methods

- **Collection of information to apply the system for relief of double taxation**
- **Voluntary disclosure of information by the taxpayer**
  - Disclosure of information on worldwide income and deductions is necessary in credit systems and should be required in exemption systems
  - In exemption system, treaty article under which exemption is being claimed
    - Possible "subject to tax" limitation
  - In credit system, amount and type of foreign tax paid and the item of income on which is was paid

Administrative aspects of exemption and credit method

- **Involuntary disclosure: need to obtain information on foreign source income if not disclosed by the taxpayer**
  - Specific information request under a tax treaty or Technical Information Exchange Agreement (TIEA)
  - Proposed rules on automatic exchange of information
  - Convention on Administrative Assistance in Tax Matters

"Second level" corporate tax

- **Treaty does not require the residence country to give double tax relief for "second level" corporate tax though the many countries do in their domestic law**
  - Is provide for in some treaties
  - "participation" exemption for dividends from foreign subsidiaries
  - "indirect" credit for the corporate level taxes paid by the distributing corporation when the resident corporate shareholder receives the dividend

Thank you

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