Summary

- Introduction: treaty design and administration of treaties
- Administration, legal certainty and prevention of conflicts
- Application of tax treaties to non-residents (business profits and services): procedures
  - Withholding v. self assessment
  - Direct application
  - Withhold and refund
  - Application subject to verification of treaty entitlement
  - Balance of factors for business profits and services
- Obtaining information to apply the treaty: business profits and services
- Application of the treaty to non-residents business profits (thresholds + interconnection of treaty and domestic law):
  - PE (art. 5 and 7 UN MC)
  - Royalties and technical services (art. 12 + draft article UN MC)
  - Independent personal services (art. 14 UN MC)
  - Employment income (art. 15 UN MC)
- Enforcement of tax claims
- Case studies

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Introduction: treaty design and administration

- A country should have treaties linked and ‘compatible’ with legislation / administrative capabilities:
  - Complexity of treaty in line with complexity of legislation and sophistication of administration
- Examples:
  - PE is complex for some countries, for them, withholdings are easier to apply
  - Definition of source in domestic law aligned with source in treaties
    - Issues with payer if for instance payer non-resident; if services provided from outside the country taxed, only effective way of taxation is withholding / no deduction of payment etc.
- New international context:
  - BEPS Action 7 (changes in art. 5.5 and 6, clarification art. 5.4. + anti-fragmentation clause, splitting of contracts: anti-avoidance or specific clause)
  - BEPS Actions 8-10 + 13
  - Mutual assistance: OECD / Council of Europe

Administration, legal certainty and prevention of conflicts (1)

- Legal certainty crucial for investors within a country
- If countries do not agree with specific provisions of treaties, they should try to have treaties that reflect their positions:
  - Articles, protocols, positions OECD MC for non Members, clear interpretation of guidelines
- Conflicts of interpretation concept of PE due to unilateral positions:
  - PE thresholds (Interpretation of ‘furnishing of services / presence test” in art. 5.3.b), art. 14 UN MC (e.g. India)
  - ‘Complex operative settlement” in Spanish tax administration and courts
- GAARs / ‘abuse taxes’ should respect treaty standard, internationally accepted principles
  - DPT in UK: first rule to counteract arrangements which avoid having a PE (requires two companies a non-resident which supplies goods or services in UK and another company that is connected with the sales or services in the UK: the avoided PE; threshold of 10 million pounds)
  - Australia: GAAR to cover structures where foreign company sells or provides services in Australia with an Australian client, there is a presence in Australia through other company connected with the contract and low taxation for foreign company (only applicable to entities with more than 1.000 million Aus dollars global turnover); proof structure designed to avoid Aus tax, to avoid PE in Aus, unless proved that substantial economic activity in territory of low taxation
Administration, legal certainty and prevention of conflicts (2)

• Conflicts of characterization of business profits / royalties / services / technical assistance / mixed contracts
• Structure of tax administration also affects treaty administration: specific procedures can be established to provide legal certainty and reduce conflicts
  – PE ‘rulings’ (BEPS Action 5)
  – Regulations, instructions on characterization of income (royalties / business profits, ancillary v. principal transactions) or application of GAARs
  – Reinforced competent authorities (Strategic Plan OECD Forum on CA)
  – Central authorities on interpretation of tax treaties
  – Specific teams and procedures for risk assessment / audits of non-residents
• Scarce resources may limit these initiatives but they are ‘investment’, not expense
  – Less litigation, more investment, more concentration on real problems

Application of tax treaties to NR (business profits and services): procedures (1)

• Para. 26.2 Comm. art. 1 OECD MC
• ‘Principle of procedural freedom’
  – Tax treaty does not indicate how it can be applied
• Different systems (only two in para. 26):
  – Self assessment
  – Direct application of tax treaty by payer
  – Direct application subject to prior administrative verification of treaty entitlement
  – Application of domestic law and later refund procedure
Application of tax treaties to NR (business profits and services): procedures (2)

- WHT system usually needed to collect information and provide funds
  - Especially in countries with strict laws on confidentiality
- WHT system applies with self-assessment
- Two options in a treaty context
  - Same WHT system for domestic / international income
    - WHT and refund
  - Different systems
    - Direct application of tax treaties
    - Combination of possibilities
- Non-resident business profits a sort of hybrid?
  - PE more similar to ‘residence’
  - Non-PEs have special features
  - But payer before-hand may not know status of recipient of income

Application of tax treaties to NR (business profits and services): procedures direct application (3)

- Withholding / reporting system, design also affects application:
  - Option between ‘permanent address’, ‘certificates’
  - Objective standard of diligence of WHT agent + penalties / non-deductions needed if system is to work,
  - But . . . assistance in collection (art. 27 UN MC / OECD: OECD / Council of Europe) may reduce pressure on WHA
- Advantages:
  - More efficient application of tax treaties: directly by payer
  - Less burden for tax authorities
  - Information provided even if no WHT applies through returns of withholding agent (‘negative returns’):
    - Relevant for business profits: information obtained about exemption
  - Effect of gross up mitigated for WHA
Application of tax treaties to NR (business profits and services): procedures direct application (4)

- Disadvantages:
  - Application of tax treaty depends on good judgment of payer of income
  - System of liability of payer / WHA is needed:
    - Standard of diligence of WHA should be clearly defined, objective liability not desirable
    - Not so easy to apply (1) beneficial ownership; (2) LOBs; (3) residence in treaty partner (certificates, address etc.)
  - WHA may refuse to apply treaties directly to avoid liability
    - Problem in the case of business profits if no withholding applied and there is a PE

Application of tax treaties to NR (business profits and services): procedures withhold and refund (5)

- Advantages:
  - Withholding tax agents have less burden: no control on whether treaty applies
  - Procedure permits to take into account expenses linked to business profits (especially services) (not only system: reductions on gross payments, reduced withholding taxes)
  - In specific sectors where large amounts of money are involved: useful to detect PEs in the refund procedure

- Disadvantages:
  - Burden for tax administrations:
    - Refund procedures
    - ‘Costs’ of interest on refunds
  - Burden for taxpayers:
    - Need to follow refund procedures (many if many sources of income or payments), delays in refunds are common
  - Procedures with administrative waivers: similar issues but advantage of one time procedure in some cases
  - Withhold and refund may be designed for specific sectors regardless of whether there is a PE or not: payments for construction, engineering projects
Application of tax treaties to NR (business profits and services): procedures verification treaty entitlement (6)

• Advantages:
  – More control ex ante on whether taxpayer has access to a treaty

• Disadvantages:
  – Administrative burden for taxpayers and tax authorities: obstacle to commercial transactions
  – Potential violation of treaty if ‘domestic procedure’ excludes taxpayer from treaty
    • Issues of form, deadlines etc.
  – Obstacle for commercial transactions

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Application of tax treaties to NR (business profits and services): balance of factors

• Legal certainty
• PEs / non-PEs
• Different thresholds for business profits / services
• Risk of avoidance
• Burdens on taxpayers, withholding agents, tax administration

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Obtaining information to apply the treaty: business profits and services (1)

- Factors:
  - ‘Hybrid’ nature of business profits / services: NR try to avoid PEs
  - PE threshold highly factual / can arise retroactively (discovered by tax administration or by factual circumstances, prolongation, delays in business transactions)
    - Overlap: taxpayer having a PE may have been regarded as not having a PE, connection of both systems should be regulated
  - But treaty may make taxpayer disclose PE: withholding on gross income, PE way out

- Different types of information:
  - From taxpayer
  - From withholding agents / subsidiaries / clients
  - From other agencies, domestic administrations
  - From the other State

  - From taxpayer
    - TINs, Registration with tax or other authorities:
      - But non-residents without PE: excessive burden, more information from payer
    - Disclosure obligations of foreign ‘representative offices’ (India), connection with art. 5.4 (very relevant to detect representative offices and auxiliary activities)
    - Returns by taxpayer: PEs (above all)

Obtaining information to apply the treaty: business profits and services (2)

- From related parties:
  - Information in tax returns: e.g distribution of products / services, transactions with non-resident related parties

- From withholding agents, subcontractors and clients:
  - Withhold and refund permits to assess if PE
  - Relevance of ‘negative declarations’ where no obligation to withhold exists
  - Deductions in returns / audits of WHA, or service providers especially in specific sectors (e.g. construction, engineering, exploration, exploitation of natural resources, banks)

- From other agencies, domestic administrations:
  - foreign investment, exchange controls, agencies issuing building permits etc.

- From the other State:
  - Art. 26 (‘on request’)
  - CbCR (automatic exchange), Action 13 BEPS (Masterfile, Localfile)

- Audits / use of internet resources:
  - GE Energy Part Inc. V. ADIT, 4 July 2014 (ITA No. 671/2011): Linkedin profile of employee relevant evidence to conclude that there is a PE in India
  - Internet information about companies (CbCR of some of them available on-line)
  - Exchange of information upon request / CbCR
Application of treaty to non-residents
business profits and services

• What treaty provision for business profits? ‘Business profits' usually not defined in treaties:
  – Civil law countries, covers all / most profits of someone carrying on entrepreneurial activities
  – Common law, not passive
• Different articles can apply:
  – Art. 6, 7, 8, 10, 11,12,13, 14,17,21 UN MC
  – Residual nature of art. 7
  – Different thresholds attribute different rights to source country:
    • Example: art. 5, 6, 8: services by engineering company, windfarm or leasing of airplane
    • Threshold designed to avoid taxation source country
    • If threshold met, form of taxation will depend on domestic law but also on drafting of treaty
• Focus on art. 5, 7, 14 and service /royalty provisions, if time, art. 15

Application of treaty to non-residents: PE threshold (1)

• PE threshold most relevant one in treaty but easy to avoid
• Production, extraction, exploration, processing, trading, sales activities etc. (not services) often require a fixed place of business and PE
• But ‘place of business’ (art. 5.1.) can be avoided with:
  – Mobile devices (e.g. vessels that enter into the country)
  – No disposal of place of business: internet
  – Subsidiaries: manufactures and production cycles of materials belonging to parent / other company
  – Fragmentation and connection with ‘per PE rule’
    • Limited effect of force of attraction
  – Art. 5.4. OECD / UN MC
• Dependent agent PE can easily be avoided (art. 5.5.)
  – Commissionaires
  – Differences UN MC / OECD: sales agent, subsidiaries remunerated at arm’s-length
• The same applies to ‘construction work’ PEs, service PEs etc. + problem of computing days in art. 5.3.b) (asymmetry with art. 14)
Application of treaty to non-residents: PE threshold (2)

- Need to design definitions / thresholds that are easier to control:
  - requirement of 'connected projects', clauses that reduce the threshold, Action 7 BEPS (limited effect)
- If threshold met, problem is attribution of profits:
  - Even if there is a PE or fixed base, what are the profits to be attributed?
- Effect of art. 12 and new provision on services UN MC:
  - Easier to administer
  - PE way out to net taxation
  - But problems:
    - 'shift of burden of the tax': need to identify sectors where that happens and whether exemptions granted
    - Gross taxation: withhold and return to deduct directly connected expenses

Application of treaty to non-residents: PE form of taxation (3)

- No direct indication in treaty but treaty may affect domestic law
- Depends mostly on domestic law
  - Definition of rules on attribution:
    - E.g. Territorial v. worldwide income attribution to PE
  - Transfer pricing rules and policy but link with art. 7 / 9 UN MC
  - Policy on deduction of expenses
  - Supported by formal obligations, to keep accounts, record keeping, etc.
- But art. 24.3 UN MC applies (non-discrimination)
  - Same material and formal obligations (e.g. returns, accountancy, payments etc.) as residents carrying on same activities, but relevant exceptions as per Commentary (e.g. transfer pricing, attribution of income, in general or sectors)
Application of treaty to non-residents: PE form of taxation (4)

- Drafting of art. 7 is also relevant:
  - AOA v. traditional approach, but domestic law must recognize AOA / traditional approach
    - Art. 7.3. UN MC: no deduction of royalties, services, interest (except banks) paid to 'head office'; no attribution of income for the same reason to PE; sort of informal attribution rule on free capital para. 18 Comm. art. 7 UN MC
  - Force of attraction of UN MC art. 7 (sales of goods and merchandise of same or similar kind to that sold by PE, other business activities same or similar kind as those carried on by the PE)
    - Captures only profits in source country
  - Apportionment methods admitted in old 2008 art. 7 OECD MC / UN MC (customary and result in accordance with art. 7)
- Connection with art. 10-12: effectively connected rule
- PE net taxation v. gross taxation if no PE, but, again, domestic law applies

Application of treaty to non-residents: royalties and technical services

- Source:
  - are domestic rules in line with treaty rules (payer v. place of performance)?
  - asymmetries in design are common for services / royalties?
- Main issue with regard to art. 12 OECD / UN MC is type of income covered (e.g. Technical assistance, services connected with royalties in mixed contracts etc.)
- If technical services article added issues are very similar (e.g. Income covered, relationship with art. 12 or art. 7, 14)
- Some countries have the position that art. 21 UN covers income from services
- Withholding agents:
  - Solve the problem of detection of PEs
  - But may have the problem of knowing the type of income covered by specific article
- No problem of attribution of profits, but problems with deduction of expenses:
  - Fictitious income taxed (not credited) if no deduction
  - Withhold and refund procedures may be needed
  - But low rates may avoid the trouble
  - Gross-up (can be avoided in targeted sectors with domestic law)
Application of treaty to non-residents: independent personal services (art. 14 UN MC)

- Characterization of income and relationship with:
  - Art. 7 UN
  - Technical services / royalty article
- Roughly same problems of PEs:
  - Is there a fixed base?
  - Attribution of income to fixed base?
  - Presence test: detection and computation of 183 days
    - Different computation in art. 5.3.b) UN MC (days of services by one or many employees) and art. 14 and 15 (days of presence single person)
  - No requirement of ‘same or connected project’
  - Asymmetry with art. 15:
    - E.g. If PE of foreign company but no presence of 183 days of person, no taxation in art. 14 but taxation in art. 15
    - Substance of relationship should be considered
  - Remote services avoid fixed base

Application of treaty to non-residents: dependent personal services (art. 15 UN MC)

- Determination of place where employment is exercised
  - Presence test 183 days not easy to detect, ‘remote work’ may avoid this test
- Determination of who the employer is
  - Guidance on commentaries on ‘economic employer’: para. 8.1.-8.28
- Determination of whether employer is a resident or has a PE in source country:
  - Not easy to know for employee, tax administration will know it and deduction of expense may be conditioned on withholding upon salaries / liability of company as withholding agent
- Quantification of income corresponding to employment exercised in country in cases of employment in and out of source country
  - Apportionment based on number of days spent in source country?
- Detection of stock options if exercised years after employment in country of source or any other ‘deferred income’
- Exception in art. 16 UN MC for director’s fees + top level managerial positions (what is that? Limited definition in Comm. art. 16 UN MC para. 4)
- Withholding + anti-abuse
Administration of tax treaties to non-residents: enforcement of tax claims

- Traditionally enforcement of tax claims linked with assets in the country or appointment of representatives:
  - Easier with PEs: fixed place / agent usually have assets in source State
  - Function of withholding agents
- But art. 27 OECD / UN and OECD / Council of Europe Convention change this situation (+ art. 26 on exchange of information):
  - Assistance in collection of tax claims
  - Requires legislation / administrations prepared for that
  - Possibility to relax 'pressure' on withholding agents and representatives, less need to appoint representatives

Case study (1)

- Non resident Co (low tax country) operates a freezing vessel through a contract with source country Co.
- All activities of NR Co (fishing, processing fish, freezing) take place in international waters but only client located in source country.
- NR Co unloads fish always in the same port in source country (near client premises) and receives supplies from service providers there (to unload, repair ship etc.).
- One of the directors lives in source country (same city of port), manages banks accounts of NR Co there and pays suppliers of services. Works from home since there are no premises of NR Co in source country.
- Another director lives in NR Co, contracts signed there before fish enters source country waters, no other relevant activity
Case study (2)

- Situation 1: two projects, two companies of the same group
  - Non resident Group of Companies entered into two different contracts re two different buildings ('construction work') with the same client for two different sites.
  - Contracts are signed so that a part of the work would be performed by NR parent Co (5 months per project), and part of the work by NR subsidiary of NR parent Co (5 months per project). The subsidiary is a party to the contracts, but overall liability assumed by NR Parent Co.
  - Does it matter whether the parent / subsidiary specialize in the parts assigned?
  - Consider also the situation of NR workers / service providers of the companies
- Situation 2: Another version of this situation would be subco is a resident of source country (fragmentation example of Action 7 BEPS+ specific clause)

Case study (3)

- Situation 1:
  - Non resident Co (low tax country) has a subsidiary (S1) in source country that sells products of NR Co in its own name but on behalf of NR Co (delivery takes places directly from NR to client, sales conditions are fixed by NR Co and S1 follows instructions of NR Co).
  - S1 was a full fledged distributor of the products before restructuring it into a limited risk distributor (remuneration based on cost-plus)
- Situation 2:
  - Same as in situation 1, but in addition to distribution functions, S1 processes raw materials in source country and stores them in a warehouse of an independent company, products are owned by non-resident Co (remuneration cost-plus)
  - S1 helps in the process of transporting the product from the warehouse to the client.
- Situation 3:
  - Same as in situation 2, but another subsidiary is used for distribution of the products