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

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Taxation of Non-residents

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1. Introduction

1.1 Scope of the Paper

This paper considers the issues faced by developing countries where a person, who is not resident in a state (a "non-resident") under the domestic law of that state (the "source state"), but whose activities either in, or with residents of, the source state, attract liability under the tax laws of that state, as a resident of a state with which the source state has a bilateral tax treaty (a "treaty"). For these purposes, only taxes on income addressed in tax treaties[1], will be considered. The issues arising in these circumstances include determining if the non-resident is entitled to benefits under the treaty and, if so

3. Income from carrying on other businesses, whether or not attributable to a permanent establishment of the non-resident in the source state.
4. Income from providing services as an employee which are exercised in the source state.
5. Income from gains realized by the non-resident in the source state.

1.2 Ensuring Compliance with Domestic Tax Law by Non-Residents Generally

For the purposes of this paper, it is assumed that the domestic laws of the source state impose tax on non-residents earning income sourced in that state and that there are administrative measures in place to enforce compliance with the domestic law. These measures will have three principal elements:

(i)

services or otherwise, of a return, in which the profit of the business and the amount subject tax is calculated. For a non-resident providing employment services in the source state, or earning passive investment income in the source state, the primary return will be made by the resident payer, disclosing the amount paid to the non-resident. Where the domestic law allows the deduction of expenses incurred to earn the income, the non-resident may be required, but will generally be motivated, to file a return claiming such expenses. A non-resident recipient of passive investment income will normally be taxed on a gross basis and no such return would be required. A non-resident realizing a gain will typically be required to file a return calculating the gain net of any allowable expenses and the tax payable.

(iii) *Collection of tax payable*

In order to enforce payment of tax and to provide a balanced cash flow to the government of the source state, recipients of passive investment income and employment income are normally subject to withholding at source by the payer in the source state. Because investment income is typically taxed on a gross basis and deductions allowable in computing employment income are often immaterial, the amount withheld will normally approximate the actual tax liability of the non-resident. Source withholding is also often applied to amounts paid to non-residents carrying on a business of providing services. This is an effective means of enforcing payment of the tax where the presence of the non-resident in the source state is transitory. It may also roughly approximate the actual tax liability of the non-resident because expenses incurred in earning services income are sometimes relatively small. Special arrangements may be necessary in the case of certain non-residents providing services.[3] In the case of business income the non-resident will normally be subject to the ordinary domestic tax collection measures, including recourse, where necessary to assets of the non-resident held in the source state. In the case of capital gains, a resident purchaser may be required to withhold a portion of the purchase price on account of any tax payable by the non-resident vendor. However, the determination of the amount to be withheld is complicated by the fact that the purchaser will know only the purchase price not the net gain.

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[3] See the discussion in Brian Arnold, An Overview of the Issues Involved in the Application of Bilateral Tax Treaties, Paper 1-A in this collection, of the treatment of athletes and entertainers at section 7.3.3.

1.3 The Connection between Tax Compliance and Source Withholding

The single most important factor bearing on the compliance by non-residents with domestic tax law is the use of source withholding by the source state. Withholding tax from the payment by a resident or enterprise of the source state to the non-resident both ensures payment of all or part of the tax liability of the non-resident and provides a strong incentive to the non-resident to comply with domestic reporting requirements in any case where the source withholding made exceeds the tax liability. While there may be some concern that source withholding, particularly where there is undue delay in processing claims for refunds by the source state, may act as a disincentive to investment or other business activity in the source state by non-residents, there are two arguments against that view. In the first place, such withholding regimes are widely, if not universally, used in developed countries and are thus not unfamiliar to potential investors. Secondly, the undoubted benefits of source withholding outweigh the possible loss of economic activity by those non-residents who would seek to avoid paying tax in the source state. There is therefore a major role for source withholding in ensuring both reporting and payment.

1.4 Effect of Tax Treaties

Tax treaties do not generally impose restrictions on the administrative policies or procedures of a contracting state. Accordingly, the source state should not be restricted by a tax treaty in imposing registration or reporting requirements on non-residents or in imposing domestic withholding requirements with respect to amounts paid to non-residents[4]. Tax treaties, however, may place various restrictions on the degree to which the source state can tax non-residents who are resident for treaty purposes in the other contracting state. In some cases, income otherwise taxable will be exempt from tax under the treaty (e.g. business income not attributable to a permanent establishment). In other cases, the rate of tax will be limited under the treaty (e.g. tax on interest, dividends or royalties). This places additional administrative burdens on the source state – determining whether a particular resident is eligible for treaty benefits, identifying the income source, which is affected by the treaty and putting in place arrangements for either reducing or eliminating source withholding to refl

different or greater reporting by the non-resident to allow the tax authorities to effectively apply the treaty.

The remainder of this paper considers specific aspects of the effects of the treaty obligations assumed by the tax administration of the source state with respect to the taxation of non-residents.

2. Taxpayer Identification Numbers

The obligations imposed by a tax treaty on a source state to give non-residents such favourable treatment as is mandated by the treaty reinforces the need for a comprehensive tax roll, which identifies both non-residents carrying on business in the source state and resident payers of salary or wages, dividends, interest or royalties to non-residents. If it is possible to combine registration for tax purposes with any registration required for general business or regulatory purposes, there may be administrative efficiencies and it may be easier for the tax administration of the source state to access information about the activities of the non-resident, which would be relevant in determining its treatment under the treaty. This might include information about the type of, or manner of carrying on, the business of the non-resident. In a federal state, or a state where general business registration may be carried out at the regional or municipal level, consideration may have to be given to co-ordinating registration with the national (or even regional) tax authorities.

While registration for tax purposes will include contact information for the non-resident, the registration document may not disclose the actual residence of the non-resident or contain information necessary to determine whether the residence of the non-resident constitutes residence for the purpose of the treaty. It is doubtful that the registration process should be used to determine treaty residence. Determination of treaty residence at that stage may slow registration and thereby hinder imposition of tax on non-residents generally and may discourage economic activity by non-residents. Where non-

3. Registration Requirements for Non-Residents

As noted above, registration is primarily required for non-residents carrying on business in the

general law purposes, efforts should be made to provide the registration information to the tax authorities and to integrate that information in the general tax roll.

A secondary issue is whether the agent or representative of a non-resident should be able to determine the treaty residence status of the non-resident and therefore to withhold at the lower, applicable treaty rate. There is no obvious, or perhaps easy, answer to this question. An agent or representative may have sufficient knowledge to determine treaty residence with a high likelihood of accuracy. In that case, and where the agent or representative is not facilitating avoidance of tax by the non-resident, giving such discretion will significantly ease the administrative burden on the tax authorities and eliminate inevitable delay in assessing refund claims, in turn removing a disincentive to inbound investment in the source state. These advantages must be balanced against the

from the tax authority in that state that the non-resident is so liable or is otherwise a tax resident of that state. This might be accompanied by a copy of a recent tax return consistent with that status. While evidence of legal residence status or other evidence of physical residence might also be tendered, those factors are not necessarily determinative of treaty residence. Alternatively, the source state may directly request confirmation of residence status from the tax authorities of the other state under the exchange of information provisions of the relevant treaty (discussed further below). If the source state requests or requires certification from the tax authorities of the other state, it can expect to be required to provide similar certification for its own residents who in turn claim treaty benefits in the other state.

In the case of interest, dividends and royalties, the non-resident must also assert beneficial ownership of the amounts in question. While this may also be the subject of an information request to the tax authorities of the other state, an independent investigation may be necessary because the other state may use a different definition of beneficial ownership for these purposes. Facts relevant to the determination, however, may be obtained from the other state.

Where the non-resident has not been subject to source withholding, tax will almost certainly have been calculated and paid on the basis of the treaty benefit or exemption claimed. Accordingly, any delay in assessing the claim by the source state will result in delay in collecting tax owed if the treaty benefit is ultimately denied. For this reason, it is important that the domestic law provide for payment of interest on tax unpaid at the due date, regardless of delays in assessment. Conversely, interest should be payable on refunds delayed because of delays in assessing treaty claims. Provision of such refund interest should mitigate concern that possible excess withholding will discourage investment and business activity by non-residents. Delays in turn will increase the likelihood of difficulty in collecting tax assessed. This underscores the importance of source withholding wherever possible.

Although source withholding is not generally applicable in the case of income from a business other than that of providing services[5], consideration might be given to requiring some withholding in respect of payments to non-residents by government or other public bodies under construction or consulting contracts with non-residents. Such payments should also be reported

[5] As noted above, because expenses represent a smaller proportion of gross revenue in some service businesses and because non-resident service providers may have only a transitory presence in the source state, source withholding is both practical and desirable in those cases.

to the tax authorities. Consideration could also be given to requiring major contractors on such projects to report payments made to sub-contractors who are, or appear to be, non-residents. Withholding rates could be set sufficiently high to create a real incentive to report and claim treaty benefits but not so as to cause cash flow problems or act as a disincentive to carrying on business in the source state.

It is noted that claims of treaty residence are unlikely to be significant in the case of employment income, which, under a typical treaty, will be taxed wholly or largely in the source state. Returns will be relevant only for claiming deductions or other applicable credits under the domestic law provisions. The same is true for dispositions of real property.

5.2 Administrative Waivers

Where source withholding is required, the non-resident or the resident payer required to withhold may be given the opportunity to obtain a waiver or ruling from the tax authorities of the source state confirming the appropriate withholding rate. The application for such a waiver or ruling is subject to the same issues as the assessment of treaty claims in a return and the same information or evidence will be required. Where the waiver or ruling is obtained, it may be desirable to require a reference to the ruling in any return made by the payer or in the return, if any, ultimately filed. Such an application raises the same issues of claims on administrative resources and delay but may be useful where repeated payments to the non-resident are likely. Consideration should be given to requiring the renewal or refreshing of such waiver claims from time to time to ensure they remain current.

5.3 Providing Information to Domestic Payers

As an alternative to providing administrative waivers or rulings, the source state might rely on domestic payers to request information from non-residents and make their own judgment on the applicability of any treaty claim for reduced or no withholding. While this is cheaper and almost certainly faster, it will only be satisfactory if the resident payers are sufficiently diligent and knowledgeable to properly assess the treaty claim asserted. In addition, domestic law measures will be necessary to penalize resident payers who fail to make the proper withholding, including through mistake or negligence in assessing treaty claims. Typically, such a delinquent payer

would be liable for the amount, which should have been withheld, together with interest and a penalty depending on the nature of the default.

5.4 Refund Claims

Dealing with refund claims by non-residents raises the same considerations of time and resources as dealing with requests for waivers or rulings or assessing claims for treaty benefits in a return. For the tax authorities the principal issue is ensuring that delay in processing claims does not adversely affect investment in the source state.

6. Information Gathering

6.1 Typical Treaty Provisions

Typical treaty provisions for the exchange of information[6] require the contracting states to exchange any information "foreseeably relevant" to the administration of any taxes (whether or not covered by the treaty) and in respect of any person (not restricted to treaty residents of the either state). They encompass regular, automatic exchanges and exchanges made spontaneously by one of the states but in most cases, the exchange will occur in response to a request from the other state. Paragraph 3(a) of Article 26 of both the UN and the OECD Model Conventions, recognizing the open-ended nature of this obligation, provides that the requested state cannot be obliged to act at variance with its laws or the "administrative practice" of it or the other state. Paragraph 16 of the Commentary to the UN Model states that paragraph 3(a) clarifies that " a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State." This therefore prevents conflicts between the domestic law of the state and its treaty obligations.

Paragraph 3(b) of both the UN and the OECD Model Conventions provides that a state is not required to provide information "not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State." The Commentary to the OECD Model

[6] See, for example, Article 26 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries, (New York, United Nations, 2011) ("UN Model Convention") and Article 26 of the OECD Model Tax Convention on Income and on Capital, (Paris, OECD, 2010, looseleaf) ("OECD Model Convention"), and the Commentaries thereon.

Convention[7] states that this extends to a state's failure to provide sufficient administrative resources and that this would entitle the other state to refuse to respond to a request on the basis of reciprocity. The Commentary to the UN Model Convention[8] on the other hand states that paragraph 3(b) is designed to prevent the imposition of "unreasonable burdens" on the requested state and makes it clear[9] that the lack of administrative resources in a state (such as a developing country) does not allow the treaty partner (such as a developed country) to refuse to respond to a request for information on the basis of reciprocity. Paragraph 20.4 of the UN Commentary to Article 26 suggests that the contracting states may wish to address such disparity of administrative capacity explicitly in the treaty.

6.2 Exposure to Exchange of Information Requests

Where the administrative resources of a state are insufficient to respond to treaty-based requests for information, it is therefore unclear, absent specific provisions in the treaty, whether it can decline such requests, on a basis of reciprocity as noted above. This will, depending on the forbearance of the other contracting state, impair

Treaty as a more convenient method of dealing with a fairly large number of countries simultaneously. Its relatively wide scope, however, dictates caution for the reasons discussed above relating to the administrative burdens involved.

8. Non-Discrimination

Paragraph 1 of Article 24 of both the OECD and UN Model Conventions provides that "nationals" of a contracting state shall not be subjected in the other state to "any taxation or any requirement connected therewith, which is other or more burdensome" than such requirements applying to nationals of the other state in the same circumstances. The administrative provisions discussed in this paper should not be considered non-discriminatory for two reasons. In the first place, they would be imposed on the basis of residence, not on status as a "national". In the second place, most of these provisions, such as source withholding and reporting requirements, are applicable to residents of the source state, not to non-residents. Furthermore, provisions applicable to non-residents, such as tax filing requirements for non-residents carrying on business in the source state or the requirement to apply for refunds, apply equally to residents and to non-residents.

9. Anti-Avoidance Rules

In general, there should not be a conflict between domestic rules designed to prevent tax evasion or inappropriate tax avoidance and the provisions of a tax treaty given the prevailing view that a treaty should be interpreted broadly to prevent use of the treaty to defeat the object and purpose of its provisions.[11] It would also be possible to specifically exempt domestic anti-abuse provisions from any treaty limitation.

The more difficult issue, particularly for a developing country, is managing the enforcement of complex anti-abuse provisions, such as transfer pricing rules, which require a high degree of expertise and administrative capacity. These rules ap

information relating to the activities of non-residents in those areas may not place an unreasonably heavy additional burden on the tax authorities. If the country does not have that capacity, adding treaty-related oblig

11. Burden of Proof