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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.

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[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 Qualify 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 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: 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

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 copyright, 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 rela

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, 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]

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 per cent of the gross amount of the dividends for

[20] See footnote 6.

[21]

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

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 otherwise 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 treat 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

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

permanent establishment. As there is no treaty benefit regarding the taxation of the interest in the

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

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 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

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

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 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

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[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

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] 49

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 types 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 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

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 cove fo oine13.7(c)8f68 TD2x.

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 request 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 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

[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

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 gain 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

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;

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[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,

- 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?

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[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 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?

law?

- 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?

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.