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United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries

Edited by
Alexander Trepelkov, Harry Tonino and Dominika Halka

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Preface

Over the past decade, the relationship between the mobilization of nancial resources for development and international tax cooperation featured prominently in the outcome documents of major United Nations conferences and summits on economic and social matters. ese include the 2002 Monterrey Consensus, the 2008 Doha Declaration on Financing for Development, as well as the outcomes of the 2009 Financial Crisis Conference and the 2010 MDG Summit. In the Doha Declaration, for instance, Member States recognized multilateral, regional and national e orts aimed at improving developing countries' abilities "to negotiate mutually bene cial investment agreements" and "to promote good tax practices."[1]

Tax treaties play a key role in the context of international cooperation in tax matters. On the one hand, they encourage international investment and, consequently, global economic growth, by reducing or eliminating international double taxation over cross-border income. On the other hand, they enhance cooperation among tax administrations, especially in tackling international tax evasion.

Developing countries, especially the least developed ones, o en lack the necessary expertise and experience to e ciently interpret and administer tax treaties. is may result in di cult, time-consuming and, in a worst case scenario, ine ective application of tax treaties. Moreover, skills gaps in the interpretation and administration of existing tax treaties may jeopardize developing countries' capacity to be e ective treaty partners, especially as it relates to cooperation in combating international tax evasion. ere is a clear need for capacity-building initiatives, which would strengthen the skills of the relevant o cials in developing countries in the tax area and, thus, contribute to further developing their role in supporting the global e orts aimed at improving the investment climate and e ectively curbing international tax evasion.

Tax treaties, and model conventions, generally do not include any guidance on how the provisions of treaties should be applied,

[1] A/RES/63/239, annex, paras. 16 and 25.

leaving this matter to the domestic law of the contracting States. Although there is a vast and growing body of literature, and ample supply of training materials dealing with the substantive provisions of tax treaties and the relationship between them and the provisions of a country's domestic law, relatively little assistance is available regarding the practical application of tax treaties. This Handbook, resulting from a joint project of the Financing for Development Office of the Untied Nations Department of Economic and Social Affairs and the International Tax Compact, is intended to contribute to filling this gap.

How do tax treaty provisions apply in practice? This question is addressed by the ten chapters comprising this Handbook. They were written by international tax experts, benefiting from extensive consultations with numerous experts from the National Tax Authorities and Ministries of Finance of developing countries. The Handbook describes best practices of countries in administering their tax treaties and identifies common denominators to the extent possible. The emphasis is on the practices of the tax authorities of developing countries. Their experts may be in a better position to assist other developing countries with less experience in this area, because they followed a similar path, often not so long ago. An effort is made to keep the material basic and practical and to focus on the procedural aspects of applying the treaty rather than on its substantive rules.

This publication was conceived, written, discussed, revised and published during a seven-month period, thanks to the enthusiasm and commitment of all involved. We hope that it serves to stimulate further discussions on the topic of the administration of tax treaties, including at capacity-development events organized by international organizations active in the area of international tax cooperation.

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We also acknowledge with gratitude the important role of members of the United Nations Committee of Experts on International Cooperation in Tax Matters, namely: Ms. Lise-Lott Kana (Chile), Mr. Wolfgang Lasars (Germany), Mr. Enrico Martino (Italy), Mr. Mansor Hassan (Malaysia), Mr. Armando Lara Ya ar (Mexico), Mr. Stig Sollund (Norway) and Mr. Ronald van der Merwe (South Africa), who contributed their expertise to this project on a pro-bono basis.

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Last but not least, we also wish to acknowledge the valuable assistance of other staff in the Financing for Development Office, namely: Mr. Michael Lennard, Ms. Irving Ojeda Alvarez, Ms. Leah McDavid, Ms. Victoria Panghulan and Ms. Mary Nolan, who provided support within their respective roles.

Alex Trepelkov, Harry Tonino and Dominika Halka
28 June 2013

Introduction

This book is a result of a project, undertaken jointly by the Financing for Development Office (FfDO) of the United Nations Department of Economic and Social Affairs and the International Tax Compact (ITC), aimed at strengthening the capacity of National Tax Authorities and Ministries of Finance in developing countries to effectively identify and assess their needs in the area of tax treaty negotiation and administration. The financial contribution for the project was provided by the German Federal Ministry for Economic Development and Cooperation (BMZ). Within the FfDO, the project was implemented, by a small team led by the Director, Mr. Alexander Trepelkov, and comprising Ms. Dominika Halka and Mr. Harry Tonino, Economic Affairs Officers, with the administrative support of Ms. Victoria Panghulan.

The ultimate goal of this project was to support the development of a comprehensive set of capacity-building tools to be used in developing countries, which would be demand driven, reflect adequately the needs of these countries, and complement the existing capacity tools.

The project was launched in December 2012. As the first step, two simultaneous technical meetings were held in Rome, Italy, on 28-29 January 2013, with the participation of 25 representatives of the National Tax Authorities and Ministries of Finance from developing countries, representing all the regions of the world. The discussion on the administration of tax treaties, held within several thematic sessions, was facilitated by selected members of the Committee of Experts on International Cooperation in Tax Matters (the Committee) and representatives of several international and regional organizations. National experts were frank in sharing their countries' experiences and concerns. The discussion contributed to: (i) identifying the needs of developing countries in the area of tax treaty administration and taking stock of the available capacity development tools at their disposal; and (ii) determining the actual skills gaps and challenges faced by developing countries in administering their tax treaties. A report of the meeting, which summarizes the main findings and details priority areas for the purposes of developing relevant capacity-building activities and tools to address these issues, is available at http://www.un.org/esa/ffd/tax/2013CBTTNA/Summary.pdf.

e e-version of this UN Handbook will be available free of charge at http://www.un.org/esa/ d/documents/UN_Handbook_DTT_Admin.pdf.

As next steps, FfDO is envisioning organizing, together with partners, an annual Forum on Administration of Tax Treaties and other capacity-development events, based on the *UN Handbook*, with a view to promoting South-South sharing in the area of current issues in the administration of double tax treaties.

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regard, it provides an introduction to the other chapters in this Handbook, which deal in more detail with the most important aspects of the application of tax treaties. In general terms, the application of the provisions of tax treaties involves questions that are ancillary to the substantive rules in the treaty, and are related to how a taxpayer obtains the benefits of the treaty. Often these ancillary questions involve procedural issues, such as filing and information requirements and the burden of proof.

There is no generally accepted definition of what is involved in the application of the provisions of tax treaties. In general, the term "application" is used to indicate that the focus is not on what the provisions of the treaty say, but how they are applied in a procedural sense. Therefore, one way to view issues involved in the application of tax treaties is to differentiate between the substantive rules of the treaty and the procedural aspects of applying those rules. This distinction is not completely clear, however, because substantive and procedural issues sometimes blend together. For example, the substantive provisions of a treaty require interpretation before they can be applied. This interpretive aspect of tax treaties can be considered to relate to the substance of the provisions or to their application, or to both. Nevertheless, for the purposes of this overview, a discussion of treaty interpretation has been excluded.

This chapter begins with a discussion of the different ways in which countries implement tax treaties into their domestic legal systems because the method of implementation may affect the requirements that countries impose on taxpayers seeking to obtain the benefits of a tax treaty. It then examines the rules provided in tax treaties that govern the way in which the provisions of the treaties are applied. In general, few rules of application are provided in the treaties themselves. For the most part, tax treaties leave the method for the application of the provisions of the treaties up to the domestic law of the contracting States. Therefore, the next section deals with the provisions of domestic law dealing with the application of tax treaties. It includes a discussion of how tax authorities determine whether taxpayers qualify for treaty benefits, how the treaty benefits are provided, and how the tax authorities of countries deal with the application of tax treaties from an organizational viewpoint. The chapter then discusses in general terms how the provisions of tax treaties are applied

prevailing over domestic law, it may be unable or reluctant to impose procedural requirements on accessing treaty bene ts to the extent that those requirements might be viewed as limiting the treaty bene ts. For this reason, a brief discussion of the status of tax treaties in relation to domestic law is provided here as background for the subsequent examination of the issues involved in the practical application of tax treaties.

e scholarly debate about monism, dualism and moderate dualism is not important for this chapter. What is important, however, for the application of tax treaties is the extent to which a country considers the provisions of tax treaties to prevail over domestic law in the event of a con ict. For countries that consider international law and treaties al ry c17(n t)J vail over domentic law in th(r)8(o)13(v) n09(.)1(o)12(f t)-11

with by the tax treaty by carving tax issues out of the trade and investment agreements.

In summary, most countries appear to have considerable freedom and exibility from the perspectives of both international law and domestic law regarding the method for the application of bilateral tax treaties. Such freedom and exibility exist despite the widely varying di erences with respect to the status of tax treaties vis-à-vis domestic law. Nevertheless, these general considerations concerning the status of tax treaties may impose limitations on the way in which a country applies the provisions of its tax treaties. One especially important aspect of this issue is the relationship between a country's tax treaties and its domestic anti-avoidance rules. is issue is discussed in the nal section.

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of dividends by a resident company to a shareholder resident in the other contracting State and Article 10 (2) of the treaty between the two countries limits the rate of tax on dividends to 15 per cent, the country can either reduce the obligation on the resident company to withhold tax to 15 per cent of the dividend paid to the non-resident shareholder or require the resident company to withhold tax at the full domestic rate of 25 per cent and require the non-resident shareholder to apply for a refund of the tax withheld in excess of the treaty rate.

e Commentary on Article 1 of the OECD Model Convention reiterates the principle that the contracting States are free to adopt procedures to implement the provisions of the treaty.[11] However, that Commentary expresses a preference for the automatic reduction in the rate of withholding as the more appropriate method for providing the bene ts of the treaty — the reduced rate of source-country tax — in an expeditious fashion. at Commentary also emphasizes that, if a country uses a refund mechanism, the refund should be provided expeditiously, unless interest is paid on the amount of the refund.

e provisions of Articles 10 (2) and 11 (2) of both Model Conventions and Article 12 (2) of the United Nations Model Convention, requiring the competent authorities of the contracting States to agree on the method by which the reductions in source country tax are to be applied, are not widely used. e competent authorities are not obligated to agree and most countries have not in fact entered into competent authority agreements as to the mode of application of these provisions.

3ebWfe aX3df[UW$&(@a`ŽV[eUd[_ [`Sf[a`) aXTafZ fZWG` [fW Nations and OECD Model Conventions may a ect the method of Sbb^[USf[a` aXafZWdbdah[e[a` e aXfZW? aWW5a` hWf[a` ež3df[UW$& (1) provides that nationals of one country shall not be subject to taxation or "any requirement connected therewith" by the other country that is di erent or more burdensome than the taxation and connected requirements to which nationals of the other country are subject. A e[_ [^Sd dWg[dW_ Wf Sbb^[Wefa efSfWee bWdea` e g` VWd3df[UW$&($)

[11]Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention. ere is no comparable statement in the Commentary on the United Nations Model Convention.

and to enterprises of one contracting State owned or controlled by dWe[VWfe aXfZWafZWd EfSfWg` VWd 3 df[UW$&(')ž W5a_ _ WfSd[We indicate clearly that the reference to "any requirement connected" to fSj Sf[a` [` 3 df[UW$&(#)ł ($) S` V (') [e [` fW`VWV fa UahWd bdaUWVgdS^ aspects related to the application of the provisions of the treaty, such as the ling of tax returns, terms of payment of tax, time and other related requirements.[12] : ai VhWd fZW5a_ _ WfSd[We a` 3 df[UW$&(') of both Model Conventions indicates that most countries do not consider that the imposition of additional information requirements or a reversal of the burden of proof with respect to transfer pricing for enterprises owned or controlled by non-residents would be discrimi-`Sfadkł [` h[a^Sf[a` aX 3 df[UW$&(')ž[13]

WafZWd SebWUfe aX 3 df[UW$&£ fZW bdaZ[T[f[a` aX V[eUd[_ [-nation against a permanent establishment in the source country of a dWe[VWf aX fZW afZWd Uag` fdk g` VWd 3 df[UW$&(%) S` V SYS[` ef dWe[VWf enterprises with respect to the deduction of payments to residents of the other country compared to the deduction of such payments to dWe[VWfe aX fZW eagdUW Uag` fdk g` VWd 3 df[UW$&(&) £ Va ` af WjfW`V to requirements connected with taxation. Accordingly, a country is not precluded from imposing di erent requirements concerning the

Commentaries indicate that the power of the competent authorities under Article 25 (3) can be used to resolve any problems resulting from the implementation of procedures for the limitation of source-country tax on dividends, interest and royalties.[19] e mutual agreement procedure is discussed in detail in chapter VIII, Dispute resolution: the Mutual Agreement Procedure, by Hugh J. Ault.

Articles 26 and 27 of both the United Nations and OECD Model Conventions, dealing with exchange of information and assistance in the collection of taxes, clearly have an impact on the application of the

tax treaties contain such rules. Italy is an exception in this regard, as it includes a provision in its treaties that requires non-residents to apply for a refund of amounts withheld in excess of the reduced rate provided in the treaty.[21] is provision also makes the time limits of domestic law applicable and requires a certi cate from the tax authorities of the residence country that the requirements of the treaty have been satis ed.

4. Rules for the application of tax treaties in domestic law

4.1 Introduction

Given the freedom provided by tax treaties to the contracting States to deal with the methods by which the provisions of tax treaties are applied, it is not surprising that country practices in this regard vary widely. Consequently, it is important for countries, especially developing countries, to be aware of the di erent methods that are available and to adopt methods that best serve their needs in light of their resources. e development of best practices for the application of tax treaties would be a useful tool for both developing and developed countries.

is section of the chapter raises several issues with respect to the application of tax treaties that countries should deal with in their domestic law. Although it attempts to identify these issues comprehensively, it does not discuss them in detail as most of them are considered in more depth elsewhere in this Handbook. e purpose of this section is to provide a comprehensive framework for thinking about how countries might provide for the application of their tax treaties in their domestic law.

Some countries have no rules in their domestic law with respect to the application of tax treaties. e absence of any application rules is understandable because, when a country rst decides to enter into

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tax treaties with other countries, it is usually preoccupied with developing its negotiating positions on the provisions of either the United Nations or the OECD Model Convention. Countries accept as a general principle that the provisions of any tax treaties that they enter into will take priority over any conflicting provisions of domestic law. As noted above, countries that require some legislative action to incorporate the provisions of tax treaties into domestic law must consider how that will be accomplished. But otherwise, it often appears to be assumed that tax treaty provisions apply more or less automatically, or that any issues concerning their application will be dealt with on a case-by-case basis as they arise.

If a country has rules for the application of tax treaties in its domestic law, several general issues must be considered. First, do those rules apply to all tax treaties or are different rules adopted for different treaties? A second issue is whether any domestic application rules are administrative or legislative in nature. Third, the rules for the application of tax treaties may be dependent on the basic method or methods of taxation — self-assessment, assessment by the tax authorities or withholding tax — adopted by a country. Closely related to, or part of, the method of taxation are the issues of the burden of proof and time limits with respect to claims for treaty benefits. Fourth, several general considerations arise with respect to the role of the country's tax authorities in applying its treaties. For example, the effectiveness and efficiency of domestic rules may be impacted by the location of respon-

application of all of its tax treaties. Such general rules would apply uniformly to all treaties and would provide certainty for taxpayers and tax officials. Although the desirability of general rules for the application of tax treaties seems obvious, very few countries have comprehensive general rules.[22] Some countries may consider that rules for the application of tax treaties are unnecessary because the ordinary procedural aspects of their domestic tax law are adequate to deal with any issues.[23]

For many countries, the rules for the application of tax treaties have developed over time on a piecemeal basis in response to specific problems arising with respect to a specific treaty or a specific article. In some cases, application of the rules may have emerged from case law rather than legislation. Such a system of specific rules may lack coherence and consistency. More importantly, the complexity of such a system may result in the denial of treaty benefits if those benefits are conditional on a taxpayer's faithful adherence to the application rules. Because of these problems, it would be worthwhile for countries entering into tax treaties to seriously consider promulgating general

concerning the equal application of a country's tax treaties is that, in principle, it is a desirable objective, although it may be subject to exceptions based on particular treaties.

4.3 Legislative or administrative rules

Country practices vary concerning the use of legislative or administrative rules, or a combination of both, to deal with the application of tax treaties. What type of law is used to deal with the application of tax treaties is a question of domestic law. In some countries, issues concerning the application of tax treaties are treated as matters of general administrative law. In other countries they are matters for tax law.[24] Further, there is the additional question of whether application rules should be the subject of binding rules of law or non-binding administrative pronouncements from the tax authorities. ere are advantages and disadvantages associated with each approach. For example, the use of binding rules provides more certainty for taxpayers and tax o -cials but the use of administrative guidance may provide more ex-ibility, as such guidance can usually be more easily revised to re ect changing circumstances.

4.4 Relationship between the rules for the application of tax treaties and the method of taxation

In general, there are three primary methods used by countries to establish the amount of tax payable by a person: assessment by the tax authorities, self-assessment and withholding. Under a system that requires the tax authorities to assess the amount of tax payable, the taxpayer is typically obligated to provide certain speci ed information and the tax authority is obligated to assess the tax payable based on that information. In contrast, under a self-assessment system, the taxpayer is obligated to le a return containing speci ed information and to determine the amount of tax payable. Under a withholding tax (which must be distinguished from a system of interim withholding

S& e character of the rules for the application of tax treaties may have implications for the resolution of tax disputes concerning those rules. Such disputes may be subject to the jurisdiction of the administrative courts or specialized tax courts.

on account of tax payable), the payer of certain amounts is obligated to withhold the amount of tax imposed, usually at a at rate on the gross amount paid, and remit such tax to the tax authorities. As a general matter, countries appear to use a combination of withholding taxes on certain payments to non-residents together with either self-assessment or assessment by the tax authorities for other amounts.

e method of taxation can have an important e ect on how the provisions of tax treaties are applied. Under a system of assessment by the tax authorities, the responsibility for applying the provisions of a tax treaty rests with the tax authorities in the same way that they must apply other aspects of the tax law. Nevertheless, some countries require taxpayers to make a speci c request for treaty bene ts and provide the information necessary to support the claim. is type of requirement makes good sense for practical reasons. Taxpayers are in a much better position than the tax authorities to know which treaty, and which provisions of it, are relevant.

If taxpayers are not required to make speci c requests for treaty bene ts, the tax authorities will be required to analyse the information provided by the taxpayer and therea er determine whether the provisions of a tax treaty are applicable. e administrative burden imposed

for exemptions, credits or reduced rates of tax based on tax treaties.[25]

income that is taxable in the source country. e taxpayer should be required to disclose the claim for exemption so that the tax authorities can verify that claim. Moreover, although the residence country exempts the foreign source income from residence country tax, it may

withholding has been reduced pursuant to the provisions of a tax treaty so that they have an opportunity to verify that the claim for reduced tax is legitimate? As mentioned above, this concern must be balanced against the interest of taxpayers receiving the benefits of reduced withholding taxes under tax treaties in a timely manner.

4.5 The role of the tax authorities in applying tax treaties

4.5.1 Introduction

Since the provisions of tax treaties require interpretation and application, the role of tax authorities of a country in performing these functions is important. In this section, three aspects of the role of the tax authorities with respect to applying tax treaties are discussed: the location of responsibility for applying tax treaties; the powers of the tax authorities relating to the application of tax treaties; and administrative guidance for taxpayers concerning the application of tax treaties.

As a general matter, the development of expertise by the tax authorities with respect to tax treaties is a critical prerequisite for their proper application. Such expertise is relatively scarce, even in the tax administrations of developed countries with extensive and longstanding treaty networks. The development of such expertise in the tax administrations of developing countries is a serious challenge.

4.5.2 Location of responsibility for applying tax treaties

One important aspect of how the tax authorities of a country apply the provisions of tax treaties is where the responsibility for that function is located in the organizational structure of the tax administration. There are many possibilities in this regard and although no single option is right for all countries, it is a matter that all countries should consider seriously. Some of the considerations that should be taken into account include:

- Whether issues involving the application of tax treaties are dealt with by a centralized unit of tax treaty specialists or by decentralized tax auditors as part of their general assessment and audit functions. If the responsibility for tax treaties is

decentralized, there should be some mechanism for ensuring co-ordination between the decentralized units. If the responsibility for tax treaties is centralized, it is important for the local auditors to be able to identify tax treaty issues so that they can be referred to the central unit responsible for tax treaties.

- How the tax administration is organized to deal with international issues in general. The provisions of tax treaties affect both residents of a country earning foreign source income and non-residents earning domestic source income. Therefore, if a country allocates responsibility for dealing with residents earning foreign source income and non-residents earning domestic source income to different units, responsibility for applying tax treaties could be allocated on the same basis. However, for many developing countries, the taxation of non-residents earning domestic source income is likely to be more important than the taxation of residents on their foreign source income.
- If responsibility for applying tax treaties is allocated to different groups or units within the tax administration, their work should be coordinated to avoid duplication and inconsistency.
- The relationship between the competent-authority function and the application of tax treaties to taxpayers.

4.5.3 The powers of the tax authorities relating to the application of tax treaties

The tax authorities must have the powers to properly investigate claims for treaty benefits. These powers include the ability to gather information and to collect tax. These powers are not peculiar to tax treaties and a detailed discussion is beyond the scope of this overview.

The power to obtain information from a country's treaty partners is particularly important for the verification of claims for treaty benefits. Article 26 of both the United Nations and OECD Model

providing the necessary information is su cient. Obviously, it is desirable if the forms are available in the languages of the country's treaty partners.

Many tax authorities provide binding rulings to taxpayers with respect to proposed transactions. ese advance rulings should also be available with respect to the application of tax treaties. In addition, taxpayers should be able to contact the tax aons. ese advan iec-11(a)-10(s)-

provisions of a tax treaty to residents of a country, and to residents of the other country, is then discussed in sections 6 and 7 below.

Time limits for claiming the benefits of a treaty cause many difficulties, especially where the domestic rules of the contracting States differ significantly. One persistent problem is the need for a taxpayer to provide information to one country before the information is available because, for example, it depends on the tax situation in the other country. Time limits are also relevant with respect to the period during which the tax authorities may reopen a matter.

5.2

5.3 The determination of residence

treaty by applying the other State's domestic law. Not surprisingly, many countries require a certificate from the tax authorities of the other country to the effect that the person is a resident of that country as a condition for granting the benefits of the treaty. The use of residence certificates is widespread and can be formalized by an agreement between the competent authorities, as provided for in Articles 10 (2), 11 (2) and 12 (2) (United Nations Model Convention only). The efficiency of the use of residence certificates can be improved if special forms for the purpose are created in the relevant languages of the two countries. The taxpayer can obtain a certificate from its country of residence and provide it to the country from which treaty benefits are claimed. Alternatively, the tax authorities of the country of residence can send the form directly to the tax authorities of the source country.

a tax treaty,[33] [f [e`af S dWe[VWf aX S Uag`fdk g`VWd 3df[UW &(#) [X [f is not liable to tax under the laws of that country. In many countries, partnerships are treated as ow-through or transparent entities for

therefore, it does not tax the capital gain because it belongs to a resident of Country B. e use of hybrid entities to obtain tax treaty bene ts raises the possible application of anti-avoidance rules. e prevention of tax avoidance through the use of tax treaties is discussed below in the nal section of this chapter and in chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Phillip Baker.

e Commentaries on both the United Nations and OECD Model Conventions provide useful guidance concerning the application of the provisions of a treaty to partnerships and their partners,[34] real estate investment trusts and collective investment vehicles.[35] However, they do not provide any similar guidance regarding trusts and other entities or on the treatment of hybrid entities generally.

5.5 Beneficial owner

e bene t of the reduced rate of source-country tax on dividends, interest and royalties under Articles 10, 11 and 12 is available only if the recipient of the payment is a resident of the other contracting State and the bene cial owner of the payment. erefore, the application of Articles 10, 11 and 12 requires a source country to determine if this is the case. According to the Commentaries, the use of the term "bene cial owner" in Articles 10, 11 and 12 is intended to deny the reduced rates of source-country tax where the payments are received by an agent, nominee or conduit and the real owner of the payment is not

%& e primary references to partnerships and their partners are found in paragraphs 2-6.7 of the Commentary on Article 1 of the OECD Model Convention and paragraphs 4-7 of the Commentary on Article 1 of the United Nations Model Convention; paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention and paragraph 2 of the Commentary on Article 4 of the United Nations Model Convention.

a resident. e precise meaning of "bene cial owner," especially as it applies to conduits, is unclear.

e OECD has recently proposed to clarify it.[36] In October 2012, the OECD issued revised proposals to amend the Commentaries on Articles 10, 11 and 12 to provide that bene cial owner has a treaty meaning independent of domestic law[37] and that it means "the right to use and enjoy" the amount "unconstrained by a contractual or legal obligation to pass on the payment received to another person."[38] However, the Commentaries will retain comments that the concept of bene cial owner is an anti-avoidance rule and must be determined "in substance."

e application of the bene cial-owner concept by the tax authorities presents some problems. e purpose of the concept is to ensure that treaty bene ts are provided only to the real owners of the relevant payments. e concept is closely related to the requirement that the recipient of the payment must be a resident of the other country, as discussed above, and to anti-avoidance rules to prevent abuse of tax treaties (the so-called anti-treaty-shopping rules). us, the bene cial-owner concept should be applied taking this context into account.

In addition, it is not completely clear where the tax authorities should look for the source of the meaning of the term bene cial owner. Presumably, the Commentary on the OECD Model Convention will TWdMa[eW [` S" #& fa [` V[USfWfZSf fZWfWd_ ZSe S fdWSfk _ WS` [` Y independent of the domestic law of the contracting States. However, the proposed OECD Commentary does not provide a meaning that is completely clear. Currently, some countries determine the meaning of bene cial owner under their domestic law, in accordance with Article 3 (2). Other countries may consider it appropriate to determine

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[36]See *OECD Model Tax Convention: Revised Proposals concerning the Meaning of "Bene cial Owner" in Articles 10, 11, and 12, October 19, 2012*, available at www.oecd.org/ctp/treaties/Bene cialownership.pdf.

[37]Ibid. Proposed paragraph 12.1 of the Commentary on Article 10, para-YdSbZ +ž# aXfZW5a_ _ WfSdk a` 3df[UW## S` V bSdSYdSbZ &aXfZW5a_ -mentary on Article 12.

[38]IbidžBdabaeW bSdSYdSbZ #Sž&aXfZW5a_ _ WfSdk a` 3df[UW#" bSdS-YdSbZ #" žS aXfZW5a_ _ WfSdk a` 3df[UW## S` V bSdSYdSbZ &ž%aXfZW5a_ -mentary on Article 12.

the meaning under the domestic law of the residence country because it is so closely related to the concept of residence as determined under fZWSi aXfZWdWe[VWUWUag` fdk [` SUUadVS` UWi [fZ 3df[UVW&ž; Xeal [f would be appropriate for these countries to require taxpayers to obtain a certi cate from the foreign tax authorities that they are both residents and bene cial owners for purposes of the foreign law.

6. The application of tax treaties by a country to its own residents

6.1 Introduction

In general, the provisions of tax treaties do not restrict a country's authority to tax its own residents. e provisions of tax treaties, however, do a ect the taxation of a country's residents, most importantly with respect to relief from double taxation and the prohibition of discrimination.[39] VSbb^[USf[a` aX3df[UVW$&(&) S` V (')ł VWS^[` Yi [fZ discrimination against resident enterprises that are owned or controlled by non-residents or that pay amounts to residents of the other contracting State, is dealt with in section 3.1 above. Typically, claims for relief from discrimination would be made by a resident in ling its tax return or making a speci c request to the tax authorities. erefore, this section focuses on relief from double taxation.

Before determining whether a taxpayer is entitled to relief from international double taxation under an applicable tax treaty, the tax authorities of a country must determine that the taxpayer is a resident of the country. e determination of residence is dealt with in section 5.3 above.

6.2 Relief from double taxation

6.2.1 Introduction

e provisions of the United Nations and OECD Model Conventions eliminate double taxation in a variety of ways depending on the type of

[39]See chapter III, Taxation of residents on foreign source income, by Peter A. Harris.

income. With respect to some items of income, exclusive taxing rights are given to the residence country. For example, this is the case for royalties under Article 12 of the OECD Model Convention, for business pro ts where the taxpayer does not have a permanent establishment in the source country, and for certain capital gains. For certain other limited types of income, for example, income from government service under Article 19, the source country is given exclusive taxing rights. In these situations, double taxation cannot arise because only one country is entitled to tax. However, for many items of income dealt with under the distributive articles of the treaty, both the source and residence countries are entitled to tax. In these circumstances, under Article 23 of both the United Nations and OECD Model Conventions, the residence country is obligated to provide relief from double taxation with respect to any income that is properly subject to tax in the source country in accordance with the treaty. Article 23 requires relief to be provided by means of either an exemption of the relevant income from residence-country tax or a credit against residence-country tax for the tax paid to the source country on the relevant income. e general issues involved in applying the provisions of Article 23, under both the exemption and foreign tax credit methods, are discussed below.

Before dealing with the exemption and credit methods for relieving double taxation, it is important to understand the relationship between a country's domestic law with respect to double tax relief and the provisions of an applicable tax treaty. If a country's domestic law provides mhe etetede5(G(t)-27(h)m)9(s)-3(t)-2(e)-(x)1(t)-20(7v)-23u(a)-35(x c

e Commentaries on Article 23 of both the United Nations and OECD Model Conventions indicate that the provisions of both Articles 23 A and 23 B "do not give detailed rules on how the exemption or credit is to be computed, this being le to the domestic law and practice applicable."[40] Because of the intimate relationshiieitiuitn

about the amount of income earned in or received from the source country in order to determine the amount to be exempted, the tax rate on other income (exemption with progression, which is expressly authorized by Article 23 A (3)), and the thresholds based on income. e Commentaries on both the United Nations and OECD Model Conventions indicate that many problems can potentially arise concerning the application of the exemption method under Article 23 A.[42] Because Article 23 A is silent about these problems, the provisions of domestic law apply. However, recourse to domestic law is not helpful if the exemption method is not used under domestic law. In such situations, the Commentaries suggest that the contracting States should adopt rules for the application of the exemption method pursuant to the mutual agreement procedure.

Countries should be especially sensitive to the possibility of double non-taxation where the exemption method is used. e Commentaries recognize that countries may agree to amend Article 23 to prevent such double non-taxation.[43] Moreover, Article 23 itself permits countries that ordinarily use the exemption method to use the credit method for dividends, interest and other income items.[44] More generally, the problem of double non-taxation involves the larger issue of the abuse of tax treaties and the relationship between tax treaties and domestic anti-abuse rules, which are discussed in section 8 below.

&$BSdSYdSbZe %*Ž&(aXfZW5a_ _ WfSdk a\` 3df[UW$% aXfZWA756 Model Convention and paragraph 16 of the Commentary on Article 23 of the G\` [fW @Sf[a\` e ? aWW5a\` hWf[a\` ł cgaf[\` Y bSdSYdSbZe %*Ž&(aXfZW5a_ -mentary on Article 23 of the OECD Model Convention.

&%For example, by agreeing to limit the exemption method to income that is e ectively taxed in the source country. Paragraph 35 of the Commen-fSdk a\` 3df[UW$%aXfZWA756 ? aWW5a\` hWf[a\` ł bSdSYdSbZ #&aXfZW5a_ -mentary on Article 23 of the United Nations Model Convention, quoting paragraph 35 of the Commentary on Article 23 of the OECD Model Convention, paragraph 15 of the Commentary on Article 23 of the United Nations Model Convention and paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

&&Paragraph 31 of the Commentary on Article 23 of the OECD Model Convention and paragraph 15 of the Commentary on Article 23 of the United Nations Model Convention.

A nal point about the application of the exemption method under Article 23 relates to the treatment of losses incurred in the source country by a resident of the other contracting State. Some residence countries may deny any deduction of such a loss because any income from the source country is exempt. In such a case, relief for the loss must be provided by the source country in the form of a loss carryover. If, however, the residence country allows a deduction for a loss occurring in the source country, the residence country is free to reduce the exemption for income subsequently derived from the source country by the amount of the earlier loss.[45] is point about losses is important because it emphasizes the more general point that the proper application of the provisions of the treaty o en involves the interaction between the treaty and the country's domestic law.

6.2.3 Credit method

As with the exemption method under Article 23 A, the provisions of Article 23 B with respect to the credit method do not contain detailed rules for the application of the credit method. erefore, similar problems of application arise under the credit method as under the exemption method. ese problems are sometimes resolved by recourse to the domestic law of the residence country relating to the foreign tax credit. However, if that country does not provide a foreign tax credit under its domestic law, according to the Commentaries, it should establish rules of application for the credit under Article 23 B and it should, if necessary, consult with the competent authority of the source country.[46]

Many issues arise in connection with the computation of a

the determination of the limitation of the credit to the portion of the domestic tax attributable to the income earned in the source country, the treatment of losses, and hybrid entities.[47] e Commentaries on both the United Nations and OECD Model Conventions indicate that these "problems depend very much on domestic law and practice, and the solution must, therefore, be le to each State."[48]

Where a country uses the credit method under Article 23 B, the deduction allowed against its tax is based on the tax paid to the other contracting State. Most countries require taxpayers to provide proof concerning the amount of foreign tax paid by presenting a copy of the foreign tax return and evidence that the foreign tax has been paid. A certi cate from the foreign tax authorities could be required for this purpose.

Although the United Nations and OECD Model Conventions do not contain such provisions, many tax treaties between developed and developing countries have "tax sparing" provisions. e purpose of these provisions is to ensure that tax incentives provided by developing countries for non-resident investors go to those investors rather than to the government of the country in which they are resident. If the residence country uses the credit method, then any tax incentives provided by the source country for investors resident in the residence country will be e ectively cancelled by the tax imposed by the residence country.

For example, assume that a corporation resident in Country A makes a large investment in developing a new mine in Country B. To attract these types of new investments, Country B provides a three-year tax holiday for the pro ts from the mine once it commences production. As a result, the pro ts are exempt from Country B's

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[47] Paragraphs 61-65 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 61-65 of the Commentary on Article 23 of the OECD Model Convention.

[48] Paragraph 66 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 66 of the Commentary on Article 23 of the OECD Model Convention.

ordinary corporate income tax, which is imposed at a rate of 30 per cent. Assuming that the corporation earns profits of one million in the first year of the operation of the mine, the corporation will pay no tax in Country B. However, assuming Country A taxes its residents on their worldwide income at a rate of 35 per cent, the corporation will pay tax to Country A on its profits from Country B of 350,000. If Country B did not provide any tax holiday, it would have imposed a tax of 300,000 and the corporation would have been entitled to claim a credit for the Country B tax against the tax payable to Country A. Therefore, the tax incentive of 300,000 in foregone tax provided by Country B is effectively transferred to Country A, whose tax increases from 50,000 (if Country B does not provide any tax holiday) to 350,000 (if Country B provides the tax holiday).

Tax sparing provisions can take various forms, and there are serious application issues with all of them.[49] In particular, tax sparing provisions are potentially subject to abuse.

7. The application of tax treaties to residents of the other contracting State (non-residents)

7.1 Introduction

In most situations under the provisions of bilateral tax treaties, it is the source country that is required to give up or reduce its tax on income earned in that country by residents of the other contracting State. Therefore, it is appropriate and necessary for the source country to take the necessary steps to ensure that the provisions of the tax treaty are applied properly. In general, these steps include:

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[49] See paragraphs 72–74 of the Commentary on Article 23 of the OECD

- Identifying non-residents subject to source-country tax under the source country's domestic law.
- Gathering information about the income-earning activities of non-residents.
- Determining whether non-residents qualify for treaty bene ts.
- Determining the amount of the reduction in source-country tax required by the treaty and the method by which the reduction should be provided.

Some of these steps have been discussed in earlier sections of this chapter and are cross-referenced here. is section focuses primarily on the identi cation of the relevant non-resident taxpayer and the application of tax treaties to the most important types of income earned by non-residents.[50]

7.2 Identification of the relevant non-resident taxpayers

Dealing with issues concerning the application of tax treaties by a source country assumes that it has identi ed the non-residents that are deriving from it income that is subject to source-country taxation. Obviously, if a source country is not imposing tax on a non-resident because it is not aware that the non-resident is carrying on business in that country or deriving income from it, there is no need to apply the provisions of an applicable tax treaty. e identi cation of non-residents deriving income from the source country is critical, both for source-country tax purposes generally and for the application of tax treaties.

Many countries use taxpayer identi cation numbers to identify taxpayers and keep track of their income-earning activities. Such numbers can be readily used for residents but some countries also require non-residents to obtain them in order to claim treaty bene ts. Although the conditions for issuing a taxpayer identi cation number are matters of domestic law, they may have an impact on the availability of treaty bene ts. For example, some countries require proof of a non-resident's country of residence as a condition of issuing a taxpayer identi cation number. It is necessary for countries to balance the

[50] See also chapter IV, e taxation of non-residents, by Colin Campbell.

administrative convenience a orded by taxpayer identi cation numbers and the burden imposed on taxpayers. e conditions for obtaining a taxpayer identi cation number should not be used as a disguised method for discouraging applying for or disallowing treaty bene ts.

In addition to taxpayer identi cation numbers, several countries require non-resident individuals and companies to register with the appropriate authorities in the source country. ese registration requirements o en apply to non-residents living in the country or doing business in the country. is information should be available to the country's tax authorities.

In some cases, the non-resident may be required to register directly with the tax authorities. e e ectiveness of registration requirements appears to vary widely. Requiring non-residents to be registered as a precondition for claiming treaty bene ts may have a small positive impact on registration. As noted above, however, if non-residents can derive income from the source country without detection by the tax authorities, claiming treaty bene ts is irrelevant.

For countries with exchange controls, there may be a link between getting permission to transfer funds out of the country and the payer's tax obligations. Some countries (for example, Argentina) require non-residents to appoint a local agent as a condition for claiming treaty bene ts. Most countries impose withholding obligations on residents who pay amounts to non-residents, which e ectively makes the resident payer the non-resident's agent for the payment of tax. is is also the case with respect to interim withholding at source on salaries and wages paid to employees and certain other amounts, including amounts paid to non-residents.

Treaty relief in the form of reduced withholding requires authorization for the resident payer to withhold in accordance with the treaty rate rather than the domestic rate. How this reduction is implemented will determine how e ciently the treaty bene ts are delivered. If, as is common practice, the withholding agent is liable

the non-resident to apply for a refund. For example, is the withholding agent entitled to reduce the amount of tax withheld based on the residence of a recipient, as indicated by the address provided by the recipient, or is more rigorous proof of residence (certification by the foreign tax authorities) required? The former procedure is capable of providing treaty benefits faster and more efficiently but is susceptible to abuse. The latter procedure has more integrity but takes longer and imposes considerably larger compliance burdens.

As noted above, the alternative to delivering treaty benefits through reduced withholding is to require non-residents to apply for refunds of amounts withheld in excess of the treaty rate. Such a refund process requires a large commitment of resources by the tax authorities to operate such a process efficiently. It is not surprising that many

7.3.2 Business profits

Once it has been determined that there is an applicable treaty, in applying the provisions of that treaty to business pro ts, the rst issue is to determine which of the several provisions of the treaty is relevant. At least six of the distributive articles of the United Nations Model Convention are potentially applicable to business pro ts: Article 6 (Income from Immovable Property), Article 7 (Business Pro ts), Article 8 (Shipping, Inland Waterways Transport and Air Transport), 3df[UW#& (;`VVbVVVVf BVVea`S^EVVdh[UVe)l 3df[UW#) (3df[efVeS`V Sportspersons), and Article 21 (Other Income). Moreover, if dividends, interest and royalties that are otherwise dealt with in Articles 10, 11 and 12, respectively, are e ectively connected with a permanent establishment in the source country, they are taxable by the source country in accordance with Article 7. A complete discussion of the various types of business pro ts is beyond the scope of this overview. It is su cient of br Td(a12

determination is intensely factual and requires the tax authorities to have good information about the non-resident's activities

source country and the local promoters of the event or the owners of the venue. If the tax authorities have di culty collecting the tax at the time of the event, they may have recourse to Article 27 to seek assistance from the country of residence to collect the tax, assuming, of course, that the treaty contains a provision dealing with assistance in the collection of taxes.

7.3.3 Income from services

Several provisions of the United Nations and OECD Model Conventions are potentially applicable to income from services.[53] e purpose of this brief discussion here is to show generally the issues that the tax authorities of the source country must confront in applying the provisions of a relevant tax treaty. ese application issues can be summarized as follows:

¾ First, the non-residents(c)-5y a3 u00(13(n)3 u00(13(76s o)12(f t)-21_0 1 Tfu

income-earning activities in the source country under Article 17 for entertainment and sports activities and for certain employees of resident enterprises and non-resident enterprises with a permanent establishment in the source country, to a time threshold (183 days) for certain other employees and independent contractors, to the necessity for a permanent establishment or a xed place of business in the source country.

¾ Fi h, the amount of the income subject to source-country tax in accordance with the treaty must be determined. Some provisions allow the source country to impose tax on the gross revenue derived by the non-resident service provider, while Articles

7.3.4 Investment Income

e treatment of investment income derived from the source country by a resident of the other contracting State under the provisions of the United Nations and OECD Model Conventions depends on the nature of the income. Dividends, interest, royalties, rental income from immovable property, and capital gains are all dealt with in di er- ent articles and in di erent ways. As with business pro ts and income from services, a detailed discussion of the application of the provisions of the treaty to investments is well beyond the scope of this overview. e purpose of the brief discussion here is to show the range of applica-

¾ In the case of dividends, interest, and royalties, it must be determined whether the recipient is the bene cial owner of the payment.

¾ e method for collecting the tax must be adopted.

As noted, in most cases, source countries use withholding taxes to collect tax on non-residents deriving investment income. Further, in most cases, the withholding tax is imposed as a nal tax, with the result that the responsibility for the steps outlined above to apply the treaty is placed on the person making the payment to the non-resident. e issues involved in balancing the compliance burden on the withholding agent and the delivery of treaty bene ts in an e cient manner i [fZ [` fVVd[fk SdVV[eUgeeVV [` eVVf[a` &ž&STahVV

 e provisions of Article 13 of both the United Nations and OECD Model Conventions dealing with capital gains present several di cult application issues. In general terms, the source country is entitled to tax capital gains from the alienation of immovable property located in the source country, the movable property of a permanent establishment or xed base in the source country, shares of a company and interests in a partnership, trust, or estate if the assets consist principally of immovable property located in the source country.[56] Other capital gains are taxable exclusively in the residence country.[57]

 e application of the provisions of Article 13 involves many of the same issues involved in applying the treaty provisions dealing with business pro ts, income from services, and investment income (for example, the necessity to establish the residence of the taxpayer). ese issues are not repeated here. e source country must obtain

the property, the proceeds of the sale, and the costs incurred in connection with the sale. ese amounts may require conversion from

domestic law, specific and general anti-avoidance rules in tax treaties, and the interpretation of tax treaties.[60] The United Nations and OECD Model Conventions contain a few provisions that might be considered

"A guiding principle is that the bene ts of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax

p o p 6 (

Some treaty abuses can be prevented by interpreting the provisions of the treaty in accordance with their purpose and the good-faith requirement as set out in Article 31 (1) of the Vienna Convention on the Law of Treaties.[65] is interpretive approach to controlling treaty abuse should also conform to the guiding principle in the Commentary on Article 1 as to what constitutes treaty abuse.[66]

e guidance in the Commentary concerning treaty abuse was extensively revised in 2011 for the United Nations Model Convention and in 2003 for the OECD Model Convention. Consequently, there is a serious issue as to the relevance and weight of the revised Commentary for the interpretation of tax treaties entered into before the respective Commentaries on Article 1 of the United Nations and OECD Model Conventions were revised. e Introduction to the OECD Model Convention indicates expressly that subsequent versions of the Commentary should be taken into account for purposes of interpreting tax treaties previously entered into.[67] Some commentators have expressed a contrary view. Ultimately, this issue may be resolved by a country's courts. Nevertheless, the tax authorities should be aware of this issue, especially in connection with the issue of abuse of tax treaties.

In general, the tax authorities of a country should apply the provisions of its tax treaties to prevent tax avoidance and evasion. is requires a careful consideration of the inclusion of anti-abuse rules in tax treaties and the adoption of domestic anti-avoidance rules that can be applied to treaty abuses. However, in addition to ensuring that the appropriate anti-avoidance rules are in place, the tax authorities

the tax base.[68] To execute this di cult balancing act properly, the tax authorities must have the necessary expertise to apply complex anti-avoidance rules, such as transfer pricing rules, to sophisticated tax avoidance transactions. e development of such expertise within the tax departments of developing countries through experience and training should be a priority.

[68]Paragraphs 100-103 of the Commentary on Article 1 of the United @Sf[a`e? aWW5a`hWf[a`ž3e`afW STahW[` eWf[a` &ž ž&ł a`W_ WZaV of providing a measure of certainty to taxpayers with respect to the possible application of anti-abuse rules is through an advance rulings process.

Chapter II

Persons qualifying for treaty benefits

Joanna Wheeler*

1. Introduction

e granting of treaty bene ts can be a fraught issue for many countries. Treaties are o en regarded as an important part of a country's international tax policy and an important tool in attracting foreign investment, yet there is also a concern that treaties can be exploited by taxpayers to obtain bene ts which were not intended by the countries

to treaty benefits and this involves the same elements as the determination made by the source country.

Entitlement to treaty benefits is often discussed in the context of the need to ensure that benefits are granted only to persons who are genuinely entitled to them, particularly in the context of treaty shopping. Treaty shopping is the phenomenon that taxpayers set up cross-border structures or flows of income, not for reasons related to the commercial aspects of their business or investment, but in order to make the income fall within the protection of a certain treaty. There is, however, also an opposite side to the coin, namely the need to ensure that treaty benefits are granted in appropriate cases, even though the fact pattern presented to the tax authority does not fall neatly within the wording of the treaty.

Treaties cannot possibly deal in detail with every factual situation that may occur in the relationship between two countries. In order to provide the necessary flexibility in dealing with this complex, and continuously changing relationship, treaties are worded in a rather abstract and general way, setting out basic principles rather than detailed rules. They raise many questions about interpretation and there may be situations in which policy considerations indicate that treaty benefits should be granted even though the treaty does not cater explicitly for the situation under consideration. It is therefore important for the tax authority to be aware of the general principles and policy issues underlying entitlement to treaty benefits in order to be able to make these decisions.

This chapter starts by explaining the three basic steps that have to be taken in determining whether or not treaty benefits are available. It then pulls together the issues raised by various types of conduit structure, which are often a major concern of source countries. It concludes by looking at a number of structures which are not covered explicitly by the United Nations Model Double Taxation Convention between Developed and Developing Countries[2] (United Nations Model Convention), in each case highlighting the feature that causes problems and discussing its effect on treaty entitlement issues.

[2]United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

investment income received by a child in the hands of a parent, in order to prevent wealthy parents from transferring their investments to their children in an attempt to avoid the effects of progressive rates of tax on the income produced by the investments. In this case there is no doubt that the child and the parent are both separate "persons" for treaty purposes. The treaty issue here is not, in fact, with the first step of identifying a person, but rather with the third step, discussed below, of deciding which person can claim treaty benefits in respect of which item of income.

2.1.2 Companies

Companies, like individuals, are generally rather straightforward in this context as they are clearly legal persons and, therefore, clearly "persons" for treaty purposes. Indeed, Article 3 (1) (a) of the United Nations Model Convention specifically defines the term "person" to include companies.

Article 3 (1) (b), in turn, defines the term "company" to mean any body corporate and any entity that is treated as a body corporate for tax purposes. The latter part of this definition means that even a legal structure that does not have the form of a company can be regarded as a company for treaty purposes if it is taxed as a company under domestic law. Once it has been determined, however, that a structure is a "person" for treaty purposes, it is not important to its entitlement to treaty benefits whether or not it is a company.[4]

Many countries allow companies in a corporate group to elect for a tax regime which recognizes that the corporate group forms an economic whole. Such group taxation regimes take many different forms. One approach is to deal with different aspects of the group relationship separately, with one set of rules to deal with inter-corporate dividends, another set of rules to deal with transfers of assets among group members and yet another set of rules to allow the transfer of losses among group members. A more integrated approach requires a computation of profit by each group member separately, but then

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[8]Subject to the one exception of Article 10 (2), where the different limits

aggregates all those results in the hands of the top company in the group and taxes only the top company.[5] At the most extreme end of the scale are countries which deal with all these aspects in one comprehensive regime which ignores the separate legal existence of the group members and imposes tax as if all the group members were branches of the top company in the group.

e latter type of group regime raises questions about the entitlement to treaty bene ts of the companies in the group, but these questions do not arise during the rst step that is discussed in this section. Even the most integrated group regime does not take away the legal personality of the separate companies in the group, but it does change the incidence of tax liability within the group and this change may have implications for steps two and three in the determination of entitlement to treaty bene ts. is issue is discussed in

At the other end of the scale are groupings and structures which do not have enough cohesion to be regarded as a body of persons under Article 3 (1) (a) of the United Nations Model Convention. A consortium, for example, is a term which is o en loosely used to denote a number of companies working together on one project; consortia are generally not formally recognized as a grouping under civil law and the formation of a consortium generally does not have any tax consequences which could lead to it being regarded as a “body of persons” g5( )ge Tw -
es w2(m)1;4c91(t)6(oa)10(t)-20(i2s1)-2ee(y o)45( )rlbrma2(m)(4n)13(c)-59 Tw -28.216 -

the tax law of the residence State in determining which structures are regarded as taxable persons for treaty purposes. Partnerships are dis-

It has concluded a treaty with State R, which limits the source-state

of a permanent establishment or xed base does change the source-

An alternative mechanism is to allow persons paying income to apply the treaty themselves and to require someone, either that person or the person claiming entitlement to treaty benefits, to report afterwards that the treaty has been applied. This alternative has the disadvantages, however, that it removes the incentive to make a timely application with the provision of full information and, if the treaty has been applied incorrectly, it leaves the tax authority in the difficult position of trying to correct the position afterwards.

In many cases, a treaty claimant will continue to receive income from the same source over many years, and it would save administrative effort if the determination that treaty benefits are available has to be made only once. On the other hand, the tax authority also has to be aware that the circumstances may change over time. Requiring a self-certification from the taxpayer that the circumstances have not materially changed may help, although it does not obviate the need for the tax authority to remain alert.

Countries will generally want to assign tax identification numbers (TINs) to non-residents who receive domestic-source income, and it may be useful to employ a pattern of TINs which distinguishes between residents, non-residents who are entitled to treaty benefits and non-residents who are not entitled to treaty benefits. In respect of non-residents entitled to treaty benefits, the TIN could also include a feature indicating which treaty applies. The residence country of treaty claimants would almost certainly assign its own TIN to a treaty claimant and, therefore, it would also be useful for the source country to require this information as a condition of granting treaty benefits and to create a link between the two numat-20(r e4)-5(gd)-19(i)1(o)13umorgd9fve-rm1(

the con nes of the exchange of information provisions of the applicable treaty and/or an additional tax information exchange agreement (TIEA).

3. Residence

Once a person has been identi ed who is potentially entitled to treaty bene ts, the second step is to determine whether that person has the required connection with a treaty partner State. e United Nations and OECD Model Conventions use the residence concept to express fZ[eUa` `Wf[a` S`VVW`WfZ[eUa`Ubf [` 3df[UW&ž WYWWdS^bZ[-losophy of this requirement is that a person is entitled to the bene ts of treaties concluded by a country only if the treaty claimant has a personal connection with that country; in most cases the required connection is one that leads to the taxation of the person in that country on worldwide income. Although this general philosophy is clear, there are some di cult borderline issues.

is section rst discusses the various elements of the residence VW`[f[a` [` 3df[UW&aXfZWG`[fW@Sf[a`e? aVW5a`hWf[a`ł^aa]-[`Y def Sf [fe TSe[UdWg[dW Wfe aX3df[UW&S`V fZW Sf fZW[eegWe that arise in connection with persons who have a residence connection with two countries. e discussion then turns to the phenomenon of limitation on bene t (LOB) provisions, which are included by a growing number of countries in their treaties to resolve the shortcomings they perceive of the residence requirement. It concludes with a brief look at the small number of treaty articles that apply regardless of residence.

As noted in the introductory chapter,[13] a source State in applying a treaty has to make a determination about the residence of the treaty claimant in the other contracting State; this determination requires a consideration of the domestic law of the residence State and therefore the source State o en requests a certi cate issued by the residence State in this respect. In order to improve the reliability of this procedure, States may nd it advisable to come to an agreement with

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[13] See chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold, section 5.3.

each other about which government body or department is authorized to issue a residence certificate and the requirements for its validity.

3.1 Liability to tax

3.1.1 Liable to tax and subject to tax

W def bSdf aXfZWdWe[VWUWWW` [f[a` [` 3df[UW&(#) ^aa] eXadfZW

company which pays no tax on its profits in a year because it has losses to carry forward which exceed the year's profit? Opinions differ about this situation; the company does not have a positive amount of tax to pay in that year, but there is also an argument that the company is subject to tax because the reduction of the losses to be carried forward has the same practical effect as the imposition of a positive tax liability.

A company that incurs losses is, however, liable to tax. The losses mean that it has a zero tax bill, but it is nevertheless within the scope of the tax law. Similarly, an individual may have only a very small amount of income and therefore not pay any tax because his

to an exemption for the whole of its income due to the nature of the person. An example would be a charitable foundation if the income tax law applies to foundations generally, but grants an exemption for charitable foundations. In such a case, however, the exemption is usually conditional on the person continuing to satisfy certain conditions, for example that the foundation carries on only charitable activities. In this case, opinion is divided as to whether the foundation is liable to tax, a disagreement which is noted in the Commentary to the United Nations Model Tax Convention.[14] The prevailing opinion, however, is that the foundation is liable to tax because the exemption is conditional and therefore does not take the foundation out of the general scope of the income tax law. Similar issues arise in respect of pension funds, which are discussed in more detail in section 6.1.

If, on the other hand, the foundation was excluded from the scope of the income tax law altogether it would not be liable to tax. So if, for example, the civil law of a country provides that foundations have legal personality and the income tax law applies to legal persons generally but excludes all foundations unconditionally, the foundation would not be liable to the income tax.

3.1.2 Extent of liability to tax

A second set of issues about the basic requirement of Article 4(1) relates to the extent of the liability to tax that is required. The Commentary to the United Nations Model Convention states[15] that this requirement refers to a comprehensive, or full, liability to tax and it is usually interpreted as referring to a liability to tax in respect of worldwide income. This interpretation is reinforced by the second sentence of Article 4(1) which excludes from the definition persons who are liable to tax only on income from a source in the potential residence State.

This aspect of the definition can cause difficulties of interpretation in respect of a small number of countries which impose income

14 Paragraph 6 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraphs 8.6 and 8.7 of the Commentary on Article 4 of the OECD Model Convention.

15 Paragraph 2 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraphs 3 and 4 of the Commentary on Article 4 of the OECD Model Convention.

as instruments for allocating taxing claims between States. In this case, the threat of actual double taxation is less important and the reason for looking for liability to tax in a country is only that it indicates a su cient personal connection between the treaty claimant and the country. A potential tax liability of the type considered in these cases would indicate the same personal connection and would therefore be su cient. An issue that might be raised by this view, however, is a lack of certainty and clarity about which situations create a potential liability to tax that satis es this test.[20] Some recent treaties concluded by countries in the Middle East, in particular, deal with this issue by not using the “liability to tax” criterion at all, instead providing explicitly that the treaty applies to persons who have a stated personal connection with one of the contracting States, such as the permanent home of an individual.[21]

3.2 Criteria for liability to tax

W[ST[^[fk fa fSj dWg[dW Wf [` 3df[UW&(#) aXfZW G` [fW @Sf[a` e Model Convention is intended to test the personal connection between a person claiming treaty bene ts and the contracting State in which fZSf bWda` US[_ e dW[VWUW3df[UW&(#)ł fZWdWXadW dWg[dW fZSf fZW liability has to be imposed for a reason that indicates a personal connection and lists a number of factors that satisfy this test. e factors listed are domicile, residence, place of management and, in contrast with the OECD Model Convention, place of incorporation, but also “any other criterion of a similar nature”.

[20]For two con icting views on the correctness of this interpretation of the residence de nition see: Baker, P., *Double taxation conventions: a manual on the OECD Model Tax Convention on income and on capital* (London: Ei Wf/& ? Sj i W^ł ^aaeVŽWSX)ł EWž&4ž') (EWbfW TWd$"" $)- S` V HaYW=žWf al., *Klaus Vogel on double taxation conventions*, 3rd edn (London: Kluwer >Si ;` fWd Sf[a` S^ł #++))ł bž$$+ł BSdSž$&Sž

[21]For example, the treaty concluded between Ireland and Qatar on 21 June 2012 provides that in the case of Qatar the term “resident of a Contracting State” includes “any individual who has a permanent home, his centre of vital interest, or habitual abode in Qatar, and a company incorporated or having its place of e ective management in Qatar.” In the case of Ireland, the treaty follows the United Nations and OECD Model Conventions in looking for liability to tax as the test of residence.

is residual sweeping-up category demands some consideration of the common element among the speci c factors listed so that one is able to determine whether or not another factor is "similar". Clearly all the listed factors relate to the personal circumstances of the person claiming treaty bene ts. In practice, given the way in which countries generally de ne the reach of their taxes, any liability to tax on worldwide income or pro t is likely to satisfy this condition.

e inclusion of the place of incorporation of a legal entity in this list of criteria may seem, at rst sight, to be subject to a risk of abuse, as the place of incorporation is rather a formal criterion. It is possible, for example, for a company to be incorporated under the law of a country but to have no substantive connection with that jurisdiction at all because the shareholders are resident in other countries and the company's management and business are both carried on outside of that jurisdiction. is situation can be the result of the historical development of the company and its business, but it can also be a deliberate strategy aimed at claiming the bene t of treaties concluded by the State. Such a strategy is, of course, increasingly feasible in an age in which global communication has become so easy that many activities can be carried on remotely.

On the other hand, it is questionable whether the speci c mention of the place of incorporation is any di erent in substance from 3df[UW&aXfZWA756 ? aWW5a` hWf[a` łSefZWb'SUWaX[` Lacbac$f[a` would be included in the residual category in that model of "other crite-

country's treaty partners use di erent criteria for the imposition of tax on worldwide pro t.

One of the consequences of this approach is that it is possible for one person to qualify as a resident of both the contracting States to a given treaty, because countries have di erent criteria for imposing unlimited taxation and also because many countries use alternative criteria for this purpose. In this case, the dual residence has to be resolved before the allocation articles of the treaty can be applied, as these articles are based on the assumption that the person is resident [` a` ^k a` WaXfZWUa` fdSUf[` Y EfSfWe 3df[UW& fZWdWXadW bdah[VWe rules, known as the tiebreaker rules, for allocating the person's residence to one of the States for treaty purposes. It is important to note that the tiebreaker provisions apply only for treaty purposes; they do not change the domestic law of either contracting State, so the person remains resident in both contracting States under their respective domestic law.[22]

3.3.1 The tiebreaker provisions and unresolved dual residence

e United Nations Model Convention has two tiebreaker provisions, one for individuals and one for all other persons. e tiebreaker proh[e[a` Xad [` V[h[VgS^e [e 3df[UW& ($ i Z[UZ eWfe agf S Z[WdSdUZk aX criteria, starting with a substantive and factual criterion and applying progressively more formal tests if the previous tests fail to resolve the dual residence. e substance of this tiebreaker provision is relatively straightforward, although there is always a risk of di ering interpretations of the tiebreaker tests it uses by the two contracting States to a treaty.

e tiebreaker provision for companies and other persons who SdW af [` V[h[VgS^e [e 3df[UW& (% i Z[UZ bdah[VWe a` ^k a` WegTefS` f[hW

[22] e domestic law of some States does, however, remove the residence of the person if the State "loses" under the tiebreaker provision of an applicable treaty. e treaty itself does not change the domestic law of the contracting

test, namely the place of e ective management (POEM). In this case, there is no recourse to progressively more formal criteria if the POEM

e ease of modern communications and transport has also made it increasingly possible to manipulate the residence of corporations by moving their management to the desired country for tax planning purposes. ese pressures have caused some States to use an alternative tiebreaker provision in their treaties which relies entirely on the mutual agreement procedure to resolve the dual residence of non-individuals. An example of such a provision is now included in the Commentary to the United Nations Model Convention.[26] is suggested provision requires the competent authorities only to "endeavour" to resolve the matter. It clearly contemplates the possibility that they will not be able to do so, stating that in that case the person is not entitled to the bene ts of the treaty at all, except to the extent that the competent authorities agree to grant treaty bene ts. Some concluded treaties go even further and do not even oblige the competent authorities to endeavour to resolve the matter, but provideted porit-9ronon-indivi

example, may refuse to give a credit for tax that is not levied by the source State of the income.

e company may also receive income from one of the two residence States. In this case the residence State that is also the source State is unlikely to grant any double tax relief, although the other residence State may do so.

3.3.2 Effect of successful tiebreaker application

If a tiebreaker provision of a treaty is applied to resolve the dual residence of a person, either an individual or an entity, it becomes possible to apply the allocation rules of that treaty. ere is also an increasing acceptance of the argument that the resolution of dual residence under the treaty between a person's two residence States may also have implications for a treaty concluded between one of those residence States and a third State which is the source of income derived by the dual resident person.

is argument is now accepted in the Commentary to the United Nations Model Convention.[27] It is based on the second sentence aX3df[UW&(#)I i Z[UZ VjUgVVeXda_ fZWdVe[VVUVW` [f[a` bVdea`e who are liable to tax in a contracting State only in respect of income from sources in the State. is exclusion was included originally to deal with diplomatic and consular sta , to ensure that they did not receive the bene t of treaties concluded by their work State but only the treaties concluded by their "home" State. It does, however, express fZWYVVdS^[` fVf[a` aX3df[UW&fa dVefd[Uf fZWTVVfeaXfdVSf[VeUa` - cluded by a country to persons whose connection with a country is considered strong enough to justify that country taxing the person on worldwide income.

is exclusion is now generally understood to support the argument that if a person is resident in two countries under their domestic law, and there is a treaty between those two countries which resolves the dual residence in favour of one of them, the person is entitled to

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treaty benefits only as a resident of that country. If, for example, a person is resident in both State L and State W and the tiebreaker allocates the person's residence to State W (the winner State), the overall effect of the allocation provisions in that treaty is that State W retains the right to tax the person on worldwide income, subject to the obligation to grant double tax relief in respect of income that may be taxed in State L. State L (the loser State), on the other hand, is permitted to tax only certain items of income from a source in State L.

If State L also has a treaty with a third State (State T), the issue then arises as to whether the person can claim the benefit of that treaty as a resident of State L. As the State L tax liability on the person is limited by the State L-State W treaty to income from sources in State L, the Commentary states that the person is excluded from claiming fdVSfk dVe[VVUW` EfSfW> Tk fZVeWa` VeWfWUVaX3 df[UW&(#) [` fZW State L-State T treaty.

This line of reasoning can be of assistance to States in combating the use of companies incorporated in a State in order to obtain the benefits of treaties concluded by that State. For example, in a case in which a company incorporated in one State (State I), but effectively managed in a second State (State M), claims treaty benefits in respect of income from a source State (State S), if each pair of States has concluded a treaty, this line of reasoning prevents the company from claiming the benefit of the State S-State I treaty. However, it is entitled only to the benefit of the State S-State M treaty, or in other words the treaty between the source State and the State with which the company has the more substantial connection. The usefulness of this line of reasoning to the source State depends, however, on State I having concluded a wide treaty network.

3.4 Limitation on benefit articles

The difficulties with the residence article in the model treaties have led an increasing number of States to include limitation on benefit (LOB) articles in their treaties. An LOB article, essentially, backs up the residence definition by requiring the person claiming treaty benefits to demonstrate more substance in the person's connection with the residence State. It is not usually the intention of States to demand full compliance with the LOB provision every single time that treaty

route income to persons who would not have enjoyed treaty protection if the income flowed to them directly. Again, the detail of this test varies from one concluded treaty to another.

The first two tests described above apply to the company claiming treaty benefits. The third common test relates, in contrast, to specific items of income for which treaty benefits are claimed. This test looks at whether the income is received as a genuine receipt of an active business carried on by the company in its residence State. To the extent that this third test looks at specific items of income rather than the treaty entitlement of the company as such, it goes beyond the role of backing up the residence definition.

Most LOB provisions also include a sweeping-up clause which gives the tax administration discretion to grant treaty benefits in cases which are not covered by the specific clauses of the LOB provisions but in which the tax authority determines that the company is not part of a structure set up in order to obtain treaty benefits.

Although LOB provisions are becoming increasingly popular, they are complex. Drafting the detail of the tests they set out requires a thorough knowledge of the economy and tax system of the two contracting States to the treaty in order to ensure that the provision targets the appropriate structures. LOB provisions also require considerable effort on the part of the tax authority to apply satisfactorily, both in selecting the cases in which to use the provision and in assessing the information provided by the treaty claimant. For these reasons, countries with limited resources in their tax administration generally prefer to use simpler provisions to combat treaty shopping. Section 5 discusses some of these alternatives.

3.5 Articles for which no residence is required

Although residence is a vital element in determining entitlement to most of the benefits of a treaty, there are three Articles that are explicitly stated to apply regardless of the residence of the taxpayers concerned. Two of these concern the administration of taxes: Article 26 on the exchange of information; and Article 27 on assistance in the collection of taxes, which was added to the United Nations Model Convention in 2011.

WfZ[dVa`W[e3df[UW$&+fZWa`ŽV[eUd[_ [`Sf[a` Sdf[UVz W main rule of this Article applies on the basis of nationality and explicitly states that it also applies to persons who are not resident in either State. Residence is relevant, however, to the extent that a di erence in the residence situation of two persons is explicitly stated to justify a di erence in the tax treatment of those persons.

A small6(i)1208-26(l)10(e o)120(t 6(b(s)-(o)13(h)12(o)1(s)-5(e912(l)i)1208-2

is to be taken from the domestic law of the State applying the treaty, unless the context requires otherwise. There have been very few suggestions that the context does require a treaty meaning for these terms. Indeed, given the variety of ways in which States attribute income to a person[29] it would be extraordinarily difficult to establish a generally accepted meaning for them.

One provision in the Model Conventions does deal specifically with the connection between an item of income for which treaty

Section 5 below, on conduit structures, discusses the artificial routing of income in more detail.

Although still part of the discussion on anti-avoidance measures, the Commentary on Article 1 of the United Nations Model Convention also makes the more general observation that the basic rules of domestic law for determining which facts give rise to a tax liability are not addressed in treaties and are not affected by them.[31] One aspect of those basic rules of domestic law is the determination of which person is taxable in respect of which item of income. This observation, in other words, reinforces the conclusion drawn above

e wording of these three Articles could be taken to suggest the latter interpretation, but it is generally regarded as incorrect. e Commentaries on the United Nations Model Convention[34] state that the limitation of the source-State tax applies if the bene cial owner of the income is resident in the other contracting State, even if the income is paid to an intermediary resident elsewhere.

Further support for this position can be drawn from a comparison with the OECD Model Convention which, in Article 12, uses only the bene cial ownership concept and does not refer at all to the income being "paid to" a resident of a contracting State. Many concluded treaties also use the bene cial ownership in this way, in Article 12 and/or Article 11. In these treaty articles, in other words, bene cial ownership is the only factor connecting the treaty claimant with the income for which treaty protection is sought. One would not expect the reach of these Articles to be materially di erent from that of comparable articles that use the "paid to" wording. is conclusion is further reinforced by looking at the consequences of interpreting "paid to" and bene cial ownership as two separate requirements, as this interpretation would create a considerable danger that no treaty bene ts would be granted at all if income were paid to a person resident in one State while the bene cial owner were resident in a di erent State, even though both those States had a treaty with the source State.

4.2.3 in 3

the treaty. ere is a large body of opinion that in this case the context does require that the term is given a treaty meaning independent of domestic law. Certainly the discussion in the Commentaries[35] strongly suggests that at least the wider contours of the concept have an independent treaty meaning. Nevertheless, some of the literature is devoted to ascertaining various national meanings of the term.

Many possibilities have been o ered as to the content of the bene cial ownership concept and consensus on this point is still very far away. Some of the suggestions for an independent treaty meaning are: that it simply excludes agents and nominees from obtaining treaty bene ts; that it refers to a person who is liable to tax on the income in the person's residence State; that it has a substantive meaning that can be derived from the common-law origins of the term; and that it has a substantive meaning that can be derived from the context in which it used. It is not within the scope of this chapter to attempt to suggest which of these meanings, if any, is the correct one, and reference is made to the bibliography at the end of this chapter in this respect.

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those two aspects. The specific characteristics of conduit structures do not usually give rise to problems in connection with the first step in this process, namely the determination of whether the legal forms used are "persons" for treaty purposes. Although many legal forms can be used for conduit purposes, they are usually forms that qualify as persons for treaty purposes.[36] This section will, for the sake of simplicity, confine the discussion to companies.

The Commentary on Article 1 of the United Nations Model Convention includes an extensive discussion about treaty shopping and possible remedies against it. Those remedies include the application of general anti-avoidance principles and judicial remedies in domestic law. These general defences are discussed in another chapter; the present chapter focuses on specific defences within the treaty.[37]

One of the problems faced by developing countries, in particular, in their attempts to combat conduit structures is a lack of information and the resources to obtain the necessary information. In other words, in addition to including the appropriate measures in a treaty, it is also necessary for countries to develop strong exchange of information networks. One measure that may help is a requirement for treaty claimants to provide a self-certification that they do indeed satisfy all the conditions for treaty entitlement. Alternatively, the requirement might be for certification by an independent auditor. It may not be workable to require a certification in every single case, in which case some guidelines would be necessary as to when the requirement applies. Experience might suggest that the certification is particularly appropriate in respect of certain treaties, for example, or in respect of treaty claimants with a certain type of ownership. Obviously the tax administration still has to remain vigilant in deciding whether or not to accept the certification.

[36]A mismatch between two countries in their characterisation of a particular legal form as a person for treaty purposes is sometimes deliberately

5.1 Characteristics of conduit structures

e essence of conduit structures is that they route income in an arti- cial way so that it falls under the protection of a treaty that would not apply in the absence of the structure. Conduit structures take many forms, but what they have in common are two interrelated features: the arti cial routing of income through multiple layers of ownership; and a disparity between the legal and economic views of the structure.

e income ow generally consists of income which is paid to the owner of an asset, such as dividends, interest, royalties and rent. is feature makes it possible to direct the income ow by placing the ownership of the assets in countries selected to create a favourable route. e income, in other words, is diverted away from the most direct route; instead it takes a more circuitous route, through multiple layers of asset ownership, before it reaches its nal destination. e structure may also involve the use of unusual vehicles in a commercial context, such as foundations, if they are necessary to ensure that the domestic law of the countries through which the income ows does not negate the advantages of the structure.

is arti cial routing of the income leads to the second common feature of conduit structures, namely the disparity between the legal and economic views of the structure. e claim to treaty bene ts of a company that is part of a conduit structure relies on the legal view. e company is usually incorporated in the conduit State and, therefore,

is used to make payments which are deductible in the conduit State, and those payments are made to other members of the group who are resident outside that State. As a result, the tax liability of the conduit in its residence State is minimal.[38]

In this situation, the economic view demands that treaty bene ts are refused, as the economic connections between the company and its claimed residence State and between the company and the income for which it claims treaty protection are both so tenuous. e challenge for countries concluding and applying treaties is to discover the cases in which the legal view is so far removed from the economic reality that treaty protection should be refused, to de ne those situations with su cient accuracy and to create appropriate legal tools for combating these structures.

5.2 Residence issues

One major point of concern in respect of conduit companies is the claim to residence for treaty purposes in a contracting State. e fundamental problem here is that there are two di erent policy issues at play.

One policy issue is whether a State regards a company as resident for its domestic law purposes, such that it wishes to tax the worldwide pro t of the company. In this case, most States regard rather a moderate connection as a su cient basis for residence, such as the simple formality of incorporation in the State. Few States require that the company, for example, carries on a substantive business in the State in order to be resident there, although this factor may be one of a number of alternative grounds leading to residence.

e other policy issue is whether a source State regards a company as having a su cient personal, or residence, connection with another State to justify granting the bene t of a treaty it has concluded with that other State. Source States are generally reluctant to apply a

[38] Conduit structures o en also take advantage of certain features of domestic law, such as a participation exemption for incoming dividends, no withholding tax on outgoing payments or other favourable treatment of certain types of income. e discussion here, however, is restricted to the application of treaties.

treaty to reduce their domestic tax claim on the basis of a very slight connection between the company and the other contracting State.

Article 4 of both the United Nations and OECD Model Conventions does not, however, set out an independent treaty test of residence; it relies on the domestic law of the claimed residence State to specify the connecting factors that make a person resident there for treaty purposes. The treaty definition, in other words, refers to a source of law designed for a different purpose, thereby introducing a policy conflict into the treaty. It is for this reason that many countries have started using the limitation on benefit (LOB) clauses discussed above.

For countries that do not wish to engage in the complexities of LOB provisions, however, there are some alternatives. One possibility, suggested in the Commentary on Article 1 of the United Nations Model Convention,[39] is that a shell company with no employees and no substantial economic activity may be disregarded for tax purposes by some countries on the basis of their general anti-abuse rules or judicial doctrines. This possibility is available, however, only in extreme cases.

Other possible responses look at the liability to tax of the conduit company in its claimed residence State; if it is not liable to tax there on its worldwide income there may well be an argument that it does not qualify as a resident of that State for treaty purposes. One reason that it may not be liable to tax on its worldwide income is that it is subject to a special tax regime. In this respect, there is a dividing line that has to be carefully observed; if the general tax regime of the claimed residence State does not impose liability on the foreign income of resident companies, it is difficult to argue that the company is not subject to the full extent of the country's tax regime. However, if the company enjoys the benefit of a special territorial tax regime, par-

Alternatively, a conduit company may not be liable to tax on worldwide income in its claimed residence State if its management is carried out in a third State. If there is a treaty between the State of incorporation and the third State, the residence tiebreaker provision of that treaty would generally assign the company's residence to the third State. In this case, the source State can use the argument explained in section 3.3.2 above to refuse treaty benefits.

5.3. Issues related to the income for which treaty protection is claimed

The second major point of concern in respect of conduit companies is their claim to treaty protection for specific items of income. In this case, the company is able to defend its claim to residence for treaty purposes, maybe because it does carry out economic activity in that State and/or its management is carried out there, but the connection between the company and the income is too slight to justify giving treaty benefits to the company in respect of that item of income.

The obvious answer to this concern is the beneficial ownership requirement, if it is the protection of Article 10, 11 or 12 that is claimed. If the conduit company does indeed do nothing more than collect income on behalf of another person, it is nothing more than an agent or nominee and therefore not the beneficial owner. In most cases, however, the conduit effect is achieved in a different way, by what is known as base erosion. Base erosion means that the income for which treaty protection is claimed is taxable as the income of the conduit company in its residence State, but that the conduit company also claims deductions for outgoing payments which greatly reduce, or erode, the income for which treaty protection is claimed. If, as is often the case, those payments are made to persons resident outside the conduit company's residence State, very little tax is collected by the conduit company's residence State on the income for which treaty protection is claimed.

A conduit structure of this sort can be created using a company which is set up specifically for this purpose, but it can also be created using a company which exists for genuine commercial purposes. In the latter case, the conduit company could be part of the group using the conduit structure, but it could also be an unrelated company which carries on a separate business, such as a bank.

the investigation by the source State. A provision, for example, that excludes the application of the treaty to back-to-back arrangements does not automatically prevent the granting of treaty bene ts to abusive conduit structures, but it does provide the source State with a basis on which to ask pertinent questions. e source State may further require the company claiming treaty bene ts to provide its tax identi cation number (TIN) in its residence State, which would alert the company to the possibility that information about the income may be provided to that State. And the source State may require the company to certify that it is the bene cial owner of the income for which treaty bene ts are claimed; such a requirement does not guarantee that the claim is well founded, but it does have a certain deterrent e ect against unjusti ed claims.103boourcne

Much more difficult, however, is the set of questions that arises when countries take different approaches to the taxation of partnerships. The possible mismatches in this respect are not confined to the relationship between the source State of the income and the State in which a partnership is established; a partnership established in one country may have partners who are resident in a different country, considerably increasing the scope for mismatches of domestic law.

partnership nor the partners are entitled to treaty benefits because none of them is liable to tax in respect of any part of the partnership income. It should be noted that that this solution looks at liability to tax as an indication of which person is entitled to treaty benefits in respect of which item of income, or in other words, in connection with the third step discussed above in the determination of entitlement to treaty benefits.[46]

This solution accords with the philosophy that treaties are intended to deal with double taxation caused by the imposition of tax by both contracting States. The assumption is that the source State wishes to tax the income in question, otherwise it would not have to consider applying a treaty. The advantage of the OECD solution is that a treaty applies when the imposition of tax liability by a residence State poses an actual threat of double taxation but that no treaty applies when there is no such threat. On the other hand, some countries find it a disadvantage that the source State's approach to the taxation of partnership income is not relevant in determining whether treaty protection is available. This solution also means that a source State dealing with partnership income has to be aware of the domestic law of the residence State of the partnership and/or partners who are claiming treaty protection. The source State could, however, require those persons to provide sufficient information about that domestic law to substantiate their claim.

6.3. Transparent/hybrid entities and corporate group regimes

The terms "transparent entity", or "flow-through entity", as they are

the source State very o en regards the entity as the taxable person in respect of that income. ere is therefore a mismatch between the two countries as to which person they regard as the taxable person. e term “hybrid entity” is o en used to describe the entity in such a case.[47]

Although there are similarities between hybrid entities and partnerships, there is also a signi cant di erence. e di erent approaches to partnerships stem from di erent domestic law concepts as to what constitutes a person for tax purposes. In the case of a hybrid entity, however, both States start from the position that the entity is a legal person and therefore a taxable person under the general tax law. e di erent approaches arise because one State applies a deeming rule attributing the income to the entity’s owners/shareholders whereas the other State does not.

In this situation, it might be more di cult for the source State to accept the tax treatment in the entity’s State of establishment as a basis for granting treaty bene ts. e consequence may well be a technical di culty in applying a treaty between the two States. e entity is not “liable to tax” in the State in which it is established and, therefore, it does not qualify as a resident for treaty purposes. e owner/shareholder, on the other hand, generally does qualify as a resident of that State (transparent tax regimes o en apply only if the owners/shareholders are resident in the State in which the entity is established), but it is not the owner of the income and, therefore, it does not satisfy the third step, discussed above, for claiming treaty bene ts in respect of that income.

Exactly this problem arose in the TDS case, decided in Canadats b3385 Tc 0

of view adds a further layer of di culty to an already di cult task of determining how to apply a treaty to trust income.

e United Nations Model Convention deals explicitly with trusts only in Article 13, in connection with capital gains from immovable property that are realised indirectly through an intermediate vehicle, such as a company, partnership or trust.[49]

6.4.1 The trust concept

An extremely important point to be made at the outset is that trusts are not legal persons or entities that are separate from the parties involved in the trust. Although it is very common to talk about trusts as if they were an entity,[51] this manner of speaking is simply a shorthand way of referring to the trust relationship. And it is the relationship between the trustees and the beneficiaries that is the essence of the trust concept.

A trust is an arrangement in which trustees own assets in a fiduciary capacity for the benefit of the beneficiaries. An alternative way of describing a trust is that it is an asset-holding and management structure, in which trustees own, invest and maintain the trust assets and collect the income from those assets, all for the benefit of the beneficiaries. The fiduciary nature of the arrangement requires trustees to put the interests of the beneficiaries before their own interests. Trusts are often discussed as if the beneficiaries are necessarily individuals, but it is equally possible for the beneficiaries to be companies or other legal entities and many trusts are established for purely commercial purposes.

One of the features of the trust relationship that causes problems for a tax system is that they are extremely flexible instruments. The interests of the beneficiaries can be defined in any way that appeals

6.4.2 Domestic taxation of trust income

Although the trust concept is well known in most common law countries, it is not true that the tax system of these states is automatically able to accommodate trusts. Quite the contrary, in fact; the tax law of these jurisdictions often has to be made to apply to trusts, usually resulting in a large quantity of legislation devoted to them. It should be emphasized that all the information about the taxation of trusts that is provided here is of a highly generic nature and subject to a large degree of generalisation. In any given case it is essential to study the relevant tax law carefully, especially as the taxation of trust income is characterised in most common law countries by a great deal of complexity and sometimes also inconsistency.

The general aim of the income tax system in common law countries is to tax trust income at the rates that are applicable to the beneficiaries, as they are the persons who enjoy the benefit of the income. Although the detail differs, these countries generally reach this result in two cases: if the beneficiary is entitled to the income as it arises to the trust; or if the income is actually distributed to the beneficiary on the exercise of their discretion to do so by the trustees.

This overall policy aim in these cases is clear, but common law States have found many different ways of achieving it. One possibility is simply to tax the beneficiary on the trust income as it arises and ignore the trustee. A second possibility is to impose a tax charge on the trustee as a representative of the beneficiary; in this case the tax is computed taking into account the personal circumstances of the beneficiary, but the liability to pay the tax is imposed on the trustee. A third possibility is to tax both the trustee[54] in respect of the trust income and the beneficiaries in respect of income they receive from the trust, but to provide a mechanism to prevent the resulting economic double taxation of the income flow. One mechanism is to allow the trustees to deduct income distributions to beneficiaries from the trust income, and another is to grant the beneficiaries a credit for the tax paid by the trustees. All of these systems are in use and some countries use different mechanisms in different circumstances.

[54] Or the trust, in countries which deem trusts to be persons for tax purposes.

If, however, the trust income is accumulated and capitalised by the trustees, there never is a bene ciary that receives the income. At some point the trustees will distribute it to a bene ciary,[55] but by that time it will be a distribution of capital.[56] In this situation, the only way to tax the trust income is in the hands of the trustees.

ere is another possibility that is found in most common law countries, namely that the trust income is taxed in the hands of the settlor/grantor. e settlor/grantor is not necessary for the operation of a trust once it has been established; once he has provided the assets subject to the trust and set out its terms the trust is fully created. e settlor/grantor is not a party to the trust relationship, as it is the trustees who are responsible for administering the trust and the bene -ciaries who have the right to enforce the trust. Nevertheless, one of the asp1.182 -4(t)-2(2d)-11(s o)12(f t)-27(h)9(e)5182 -4tl2v Tdu[2Dd 7(m)9(o)13

is paid to trustees in that partner State for the benefit of beneficiaries resident in that same State. One solution is to accept that the management functions of trustees in respect of the income are sufficient for the trustees to qualify as beneficial owners for treaty purposes.[58] Another solution is to provide in the treaty that treaty benefits are available to trustees if all the beneficiaries are resident in the same State, but there is an obvious limitation on the effectiveness of this solution if even one beneficiary is resident elsewhere. A proportional approach, which would grant treaty benefits to the extent that the beneficiaries are resident in the same State, suffers from the difficulty that it may

6.4.4 Residence of trustees

A second set of problems arises in connection with the second step in determining entitlement to treaty benefits, namely, the residence of trustees for treaty purposes.[64] This issue arises, of course, only if it is decided that the trustees are the correct persons to claim the benefit of a treaty.

Although it is possible for a trust to have only one trustee, many trusts have two or more. The trustees of a single trust are generally accepted to constitute a "body of persons" and are therefore capable of being a person for treaty purposes. In countries that recognize the trust concept, a body of trustees is almost always capable of bearing a tax liability and, therefore, the body of trustees is also capable of being a resident of a contracting State for treaty purposes.

Determining the State in which a body of trustees is resident is, however, a much more difficult issue. The case law in common law countries is not consistent in this respect. Some case law looks at the personal residence of the companies or individuals who fulfil the role of trustee, but there is an obvious problem with this approach if the trustees have their personal residence in different States. Furthermore, the relevance of the trustees' personal residence is not immediately obvious as the trustees do not necessarily carry out their trustee activities in their personal residence State.

From a policy point of view, the preferable choice is the place where the management of the trust is carried out. This view seems to

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in particular, the distributive rules in Articles 6 through 21. In most cases, though not all, an express taxing right of the residence country is referred to.

ese distributive rules of tax treaties also grant taxing rights to the contracting State that is not the residence country, for the purposes of this chapter referred to as the "source country". It is, perhaps, accurate to say that when a treaty grants a source country a right to tax, the source of the income is located in that country. However, it is not accurate to suggest that the right of a source country to tax under tax treaties represents a comprehensive set of rules for determining the source of income. Consistent with the purpose of tax treaties in eliminating double taxation and as a mechanism for allocating taxing rights between countries, tax treaties limit the rights of source countries to tax income that may, according to general principles, be considered to be sourced in that country. So there are many circumstances in which income may be considered to have a source in a particular country, but that country is not granted a taxing right under tax treaties.

Consequently, for the purposes of this chapter, "foreign source income" with respect to a country is taken to mean income that according to general principles does not have a source in that country. Foreign source income includes, but is not limited to, income that may be taxed under a treaty by a treaty partner on a basis other than residence of the person deriving the income. Further, "foreign source income" may be, according to general principles, considered sourced in a treaty partner or sourced in some third country. In the latter case it is referred to as "third country income". is analysis is not intended to suggest that there is general agreement on how to locate source according to general principles, but that is not something regulated

intended to directly limit residence country taxing rights,[6] although, as pointed out below, this may happen indirectly and particularly under other provisions of tax treaties. It seems that any reference to residence country taxing rights in the distributive rules of tax treaties is o en used as a method of limiting source country taxing rights. is is particularly the case where the distributive rules say that certain income "shall be taxable only" in the residence country, with speci c exceptions where the source country is granted a right to tax.[7]

Less clear is whether the reference to residence country taxing rights in the cases of Article 10 (Dividends), Article 11 (Interest) and Article 12 (Royalties, United Nations Model Convention only) may be considered simply as a mechanism for limiting source country taxing rights. ese provisions say that the residence country "may" tax and go on to symmetrically refer to situations when the source country "may also" tax. A di culty is in determining the scope of these provisions because they only refer to dividends, interest or royalties "paid" by a resident of a contracting State to a resident of the other contracting State.[8] It is generally accepted that these rules do not

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[6]Article 19 (Government service) of both the United Nations and OECD Model Conventions is an exception. is provision is intended to directly limit residence country taxing rights.

[7]For example, this is the approach in Article 7 (Business pro ts), Article 8 (Shipping, inland waterways transport and air transport, although using a proxy test of residence), Article 12 (Royalties, OECD Model Convention, but not the United Nations Model Convention), Article 13 (Capital gains), Arti-UW#&(; ` VWbWVWf bWea ` S^eWh[UW G ` [fW @Sf[a ` e ? aWV5a ` hWf[a `)ł Article 15 (Dependent personal services), Article 18 (Pensions and social security payments), Article 19 (Government service) and Article 21 (Other income). Analysis of Article 20 (Students), which speci es a contracting State in which certain income "shall not be taxed", is more complex. See also paragraph 6 of the Commentary on Article 23 of the OECD Model Convention, dWbdaVgUW [` bSdSYdSbZ #&aXfZW5a_ _ WfSdk a` 3df[UW$%aXfZWG` [fW Nations Model Convention.

[8]Articles 11 (5) (of both the United Nations and OECD Model Conventions) and 12 (5) (United Nations Model Convention only) extend the scope of the Articles on interest and royalties to interest and royalties "borne" by a permanent establishment or xed base (United Nations Model Convention only) in one contracting State and "paid" to a resident of the other contracting State. Under these extending source rules, the residence of the "payer" is irrelevant.

the residence country. is rule is not targeted at the calculation of foreign source income, but can have application in that context. It has no application except with respect to deductibility of amounts and so does not apply to tax rates or tax reliefs such as tax credits.

While these provisions prevent discrimination in the taxation of foreign source income based on nationality, ownership, control or recipient of payment, they do not prevent discrimination in the taxation of foreign source income as such. So, for example, provided those rules are not engaged, a residence country is at liberty to impose more tax on foreign source income than on equivalent domestic source income, whether that be by reason of tax rates or the availability of deductions or reliefs. Tax treaties simply do not engage with this sort of discrimination. Similarly, tax treaties do not expressly prevent more or less taxation by a residence country of income derived by its residents from some foreign countries (including tax treaty partners)

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corresponding adjustment rules are primarily targeted at the allocation of source of income between countries. However, they are not limited in that regard and in an appropriate case can be applied to residence country taxation of foreign source income.

1.3.3 Elimination of double taxation

The primary manner in which residence country taxation of foreign source income is affected by tax treaties is the obligation to eliminate double taxation of income that has already been taxed in the source country (Article 23). There are two alternative versions of Article 23 — the exemption method (Article 23 A) and the credit method (Article 23 B). Details of the manner in which these provisions are to be administered in the residence country are discussed below. It is first important to identify some limitations as to the scope of the obligation in Article 23 and then to consider how countries respond to those limitations.

Article 23 (whether Article 23 A or 23 B) obliges the residence country to eliminate double taxation of income of a resident that "in accordance with" the tax treaty "may be taxed" in the other contracting State. In this context, it is irrelevant whether the income can be correctly described as sourced in the other contracting State. The issue is simply whether according to the distributive rules of the tax treaty the other contracting State has a right to tax or not. The OECD (though not the United Nations) confirms that whether the other contracting State has a right to tax or not is to be determined by that other contracting State applying the tax treaty to its own law.[14] The right to tax (and so the residence country's obligation to provide relief) is not tested by asking whether the other contracting State would have a right to tax if residence country law were applied. Thus, if the residence country tax administration wishes to question the source country's right to tax (and so the residence country's obligation to provide relief), it must engage in the difficult task of applying the tax treaty to the law of a foreign country, that is to say, the law of the source country. This does

[14] Paragraphs 32.1–32.4 of the Commentary on Article 23 of the OECD Model Convention. See also the discussion in Peter A. Harris and David Oliver, *International Commercial Tax* (Cambridge: Cambridge University Press, 2010), pp. 277-8.

not mean that a residence country must agree with the source country as to the facts of a particular case or the proper application of a treaty.[15]

is approach in Article 23 means that elimination of double taxation by a residence country under a tax treaty is o en narrower, and can be substantially narrower, than under unilateral relief rules.[16] First, where the source country has no right to tax under a tax treaty, the residence country has a full right to tax (in which case relief from double taxation is e ectively provided by the source country). Second, the obligation to provide relief only extends to source country taxes covered by the treaty. ese are outlined in Article 2 and under the Model Conventions extend to "substantially similar taxes" to those mentioned therein. Any taxes that are not so similar and, where that extension is not present in a treaty, taxes not mentioned in the treaty do not fall within the residence country's obligation to eliminate double taxation. ird, it is usual for tax treaties to only cover taxes imposed by the contracting States and sometimes this does not extend to income taxes imposed by lower tiers of government, especially where the source country is a federal country.[17]

Finally, Article 23 only covers juridical double taxation (taxation of the same person with respect to the same income) and not economic double taxation (taxation of di erent persons with respect to the same income).[18] e major example of economic double taxation is the taxation of a corporation with respect to its pro ts when derived and the taxation of distributions of those pro ts in the hands of the corporation's shareholders without relief for one tax against the

[15]See paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

[16]

other. For example, when a foreign subsidiary distributes a dividend to a local parent corporation, tax treaties presume that the source or host country will tax the pro ts of the subsidiary and impose at least a limited withholding tax on distributions to the parent. In addition, tax treaties presume that the residence country of the parent will tax the distribution in full and only eliminate juridical double taxation by providing a foreign tax credit for any withholding tax imposed. If capital exporting countries adopted this approach, it would place a substantial limitation in the way of cross-border direct investment and a great incentive for any such investment to be structured in a way to erode the source/host country corporation tax base of the subsidiary, for example, by ensuring deductible payments are made to the parent rather than non-deductible dividends.[19]

In passing, it may be noted that model tax treaties do provide for the elimination of some forms of economic double taxation, although not in Article 23. In particular, where a contracting State (for example, the source country) makes a transfer pricing adjustment under Article 9 (1) with respect to one party to a transaction, full taxation by the other contracting State of the other party to the transaction may result in a form of economic double taxation. A similar form of double taxation can arise in the context of an adjustment to the allocation of pro ts to a PE under Article 7 (2). In this context, the obligation on the other contracting State to make a corresponding adjustment to the pro ts of the other party under Article 9 (2) (or, in the context of a PE, Article 7 (3) of the OECD Model Convention only) can be viewed as a form of relief from double taxation. Further, Article 25 (3) provides that the competent authorities of the contracting States may consult for elimination of double taxation not covered by the tax treaty. ere is no obligation to reach agreement in this regard and in practice this provision is rarely used and is not used as a general mechanism to provide relief from economic double taxation of corporate income.

ese limitations as to the scope of Article 23 mean that ( )]TJu8.-2(o)10(p10

is not true of Article 23. It is standard practice for tax treaties to split Article 23 into a part providing for the elimination of double taxation by one contracting State and another part providing for the elimination of double taxation by the other contracting State.[20] In doing so, many countries will also make provision for relief of economic double taxation of corporate income where a subsidiary in the other contracting State distributes a dividend to a parent corporation resident in the subject country. By contrast, it is rare (and increasingly so) for tax treaties to provide for relief from economic double taxation of corporate income derived by portfolio shareholders (for example, individuals and non-substantial corporate shareholders) through a corporation. Any such relief for portfolio shareholders is usually provided unilaterally in the domestic law of the residence country.

As mentioned, the obligation to provide tax treaty relief for the elimination of juridical double taxation typically depends on whether the source country has a right to tax when applying the tax treaty to that country's tax law. Most commonly, treaty provisions for relief from economic double taxation (where they exist) do not follow this approach. For example, the application of such provisions is not dependent on the distribution in question falling within the de nition of "dividend" in Article 10, as applied by the source country. In providing relief from economic double taxation, o en there is a separate reference to "dividend" in the Article on elimination of double taxation, which does not draw its meaning from Article 10. Rather, the meaning of any reference to "dividend" in the Article on elimination of double taxation (absent any express de nition) will be determined by the residence country applying the tax treaty to its own law, and Article 3 (2) of the treaty may be relevant in this regard.

Another general limitation on the application of Article 23 as found in model tax treaties is that it is relatively brief and so does not elaborate on many of the details that are o en necessary in applying the provision in practice. Other provisions in tax treaties that su er from brevity are o en supplemented with extensive commentary or guidelines, but that is not the case with Article 23. As a result, residence

[20]See paragraph 30 of the Commentary on Article 23 of the OECD Mod-W5a`hWf[a`ldMbdaVgUW[` bSdSYdSbZ #&aXfZW5a_ _ WfSdka` 3df[UW$% of the United Nations Model Convention.

countries often need to create domestic rules (statutory or otherwise) detailing the manner in which double taxation is to be eliminated under its tax treaties.[21] For this reason, it is common for the part of the Article on the elimination of double taxation that applies to a particular contracting State to refer to the provisions of that State's domestic law that eliminate double taxation. These domestic law rules may apply only to tax treaties, but more often they form the basis of unilateral foreign tax relief granted by that country, a matter considered below.

1.4 Unilateral foreign tax relief

The vast majority of developed countries and many developing countries unilaterally in their domestic law provide relief from double taxation of foreign source income of residents. Unilateral relief often (though not always) reduces the impact and significance of the obligation to provide elimination of double taxation under tax treaties. This may happen for a number of reasons. First, as mentioned, the elimination of double taxation Article in many tax treaties refers to and is limited by the scope of the domestic law rules. Second, there are instances where the method of foreign tax relief offered unilaterally is more generous than that offered under a tax treaty, in which case the taxpayer is typically entitled to insist on the unilateral relief. This particularly happens where a country's tax treaties incorporate the foreign tax credit method and the country later unilaterally implements the exemption method. Third, the scope of the unilateral relief may be broader than that available under tax treaties, such as where unilateral relief incorporates relief from economic double taxation of corporate income but tax treaties do not or where unilateral relief extends to taxes not covered by tax treaty relief (for example, excess profits taxes or State or local government income taxes, if these are not covered by a treaty).

Unilateral foreign tax relief rules are substantially different as to their structural features when compared with tax treaty rules. In particular, they are not confined by reference to a treaty; rather domestic

[21]See paragraphs 38 and 60 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention.

law of the residence country will rule all aspects of scope of the relief. So, in applying unilateral rules a residence country must identify what is foreign source income for which relief is available and how that income is to be calculated (including the allocation of expenses). Contrast tax treaties, where (as mentioned above) it is the right of the source country to tax that determines the residence country's obligation to provide relief. Unilateral rules must identify when foreign taxes are sufficiently similar to domestic taxes to qualify for relief. This can be a difficult matter. Contrast tax treaties, which often clearly identify taxes to be credited (although that clarity can be blurred if the "substantially similar tax" requirement is engaged). Unilateral rules also usually provide for a nexus between the foreign tax and the foreign income in order to qualify for relief, for example, the foreign income must (according to the rules of the residence country) be seen to have a source in the foreign jurisdiction that imposes the foreign tax.

2. Administering the mechanics of elimination of double taxation

Effective administration of the mechanics of elimination of double taxation requires an understanding of the accepted rationale for such relief. It is widely accepted that the obligation on the residence country to eliminate double taxation of foreign source income is consistent with the principle that the source country has the first right to tax (source country entitlement principle). This principle suggests that where a source country exercises a legitimate right to tax the residence country should not tax in such a manner as would result in double taxation. Relief from double taxation of cross-border income is consistent with a global view of allocating resources efficiently. As Article 23 illustrates, the main methods for elimination of double taxation are the exemption and foreign tax credit methods.[22]

The following analysis considers the main features in administering, first, the exemption method for elimination of double taxation and, then, the credit method. Each of these methods raises issues as to how expenses should be allocated between the foreign source income in

[22] It is conceptually possible for a residence country to reduce the rate of tax on foreign source income, but this is rare.

question and other income of the person deriving the income (whether domestic source income or other foreign source income). The allocation of expenses can have a dramatic effect on the quantum of relief available and yet is subject to few, if any, rules in tax treaties. This is the third matter considered below. Finally, the focus turns to the mechanics of the elimination of economic double taxation of corporate income on distribution, that is to say, the taxation of foreign source dividends, whether that relief is provided unilaterally or by tax treaty.

2.1 Exemption method

The exemption method is conceptually simple. It suggests that if income has been appropriately taxed in the source country then the residence country should eliminate the potential for double taxation by exempting the foreign source income. The mechanics of administering an exemption system are not so simple, particularly if the residence country wants to ensure that the system is not open to abuse. If there is a lack of taxation in the source country, then the residence country providing an exemption for foreign source income means the income is not taxed at all. This can distort an efficient allocation of resources and defeat the rationale for the residence country providing relief.

For this reason, tax treaties typically limit the exemption method to income that may be fully taxed in the source country, such as income from land, business (PE), professional services and employment. However, Article 23 A (1) does not require that the source country actually tax. The fact that the source country "may" tax is sufficient to oblige the residence country to exempt the foreign source income. This can be particularly problematic where the residence country has assessed (sometimes incorrectly, because it references its own tax law) that the source country may tax, but the source country does not agree or intentionally does not tax. A good example of this is where the source and residence countries do not agree as to the scope of what is

Article 23 A (3). Exemption with progression is only relevant where the taxpayer is subject to progressive tax rates. It means that exempt for-

Exempt foreign source income may also have an impact on other residence country tax attributes of the person deriving the income. The most obvious example is the use of tax losses. Most countries allow losses, especially from business activities, to reduce income from other activities or be carried forward. Where losses are available, a question is whether those losses are to be reduced by exempt foreign source income, which would mean that the losses are not available to reduce other, taxable income. This is a matter that is not regulated by tax treaties. As such, it is a matter for domestic law. Again, there are different types of rule that may be applied in this regard, from no requirement to use the losses against exempt foreign source income, to a requirement to first fully reduce any losses by exempt foreign source income. It is also possible to use apportionment rules and have a different treatment depending on whether the loss is from a foreign or domestic source.

Box 2

Exempt foreign income and domestic losses

A resident has a carried forward loss of 100 from domestic activities. In

2.2 Credit method

e foreign tax credit method is the other main method by which residence countries eliminate double taxation of foreign source income and, as mentioned regarding the exemption method, is typically at least the residual method. is method is explicitly provided for in Article 23 B of the Model Conventions, although this provision is brief and does not contain many of the details required20(i)-5(s m)9717(n 2i)-5(s m)9

Box 3

Limitation on credit — Excess foreign tax credits

A resident derives 100 foreign source income. e foreign income is
fSjW[` fZWeagdUWUag` fdk Sf fZWdSfWaX&" bWdUWfz WdWe[VWVUW
country eliminates double taxation in the form of a foreign tax credit.
e residence country taxes at2(4)6(o)9(n (d)-2371e04)5-19(nc)-90d prx cnt.

Under the domestic laws of a number of countries, the credit is simply limited to the amount of domestic tax due with respect to foreign source income. Such an approach does not permit excess relief. Other countries do take into account the amount by which foreign tax may exceed domestic tax, for example, by recognizing excess foreign tax credits and permitting these to be carried forward for use in future years.

Box 4

Limitation on credit — country-by-country approach

A resident of Country B derives 100 business pro ts from Country A and 100 interest from Country A. e tax rate on business pro ts in Country A is 30 per cent and Country A imposes a nal withholding tax of 10 per cent on interest paid to non-residents. Country B taxes the resident at 20 per cent.

Country A tax

Business income	100
Source tax at 30 per cent	30
Interest income	100
Source tax at 10 per cent	10

Income net of foreign tax	160

Country B tax

9daeeŽgb (%' #')	&'

Taxable income	200
DVe[VVUWfSj Sf $" bWdUWf	&'
Less foreign tax credit (^l_ [fWfa dVe[VVUWfSj)	&'

Net residence tax	0

Net return	160

If separate calculations were required for calculation of the foreign tax credit for the business income and the interest income (that is to say, an item-by-item approach) then the credit for source tax on the business pro ts would have been limited to 20, that is to say, the residence country tax on those pro ts. ere would have been excess foreign tax of 10 (30 - 20) for which no foreign tax credit would be available due to the limitation on credit. Further, there would have been 10 Country B tax payable with respect to the interest income because the Country B tax on this income exceeds the source tax by this amount. By using

Irrespective of whether excess foreign tax credits may be carried forward or back, foreign tax credit systems must incorporate rules as to the scope of calculating the limitation on credit. Article 23

separate limitation on credit calculation for particular types of foreign source income, for example, all business profits, all income from immovable property, all passive income, all capital gains, etc. This is often referred to as a type of income or basket limitation on credit, in which case the particular country from which the income is derived may be irrelevant. The worldwide and type of income approaches to the limitation on credit may be designed in such a way as to be consistent with the manner in which income is required to be calculated under domestic law, for example, according to a global or schedular approach (examined below).

Foreign tax credit systems also give rise to issues as to the manner in which a residence country taxes foreign source income. This was touched on in section 1.3.1 above, in the context of non-discrimination. Questions arise as to what expenses are deductible, if any, in calculating foreign source income and this can have a dramatic effect on calculating the limitation on credit. Deductions are dealt with in section 2.3 below. Further issues arise as to the rate at which a residence country taxes foreign source income. Some countries apply special tax rates to particular types of income, for example, dividends and capital gains are often subject to lower tax rates than other types of income. One question is whether these lower rates apply to foreign source income of the relevant type. While tax treaties do not typically deal with such issues, Article 23 requires a foreign tax credit to be granted irrespective of the domestic tax rate on the foreign source income (see the example in Box 6). Similar issues arise as to whether and in which manner particular reliefs (such as foreign source losses and allowances and tax credits available for things like research and development) are available with respect to foreign source income.

The taxation of foreign source income by a residence country at non-uniform rates can also have an impact on the manner in which the limitation on credit is calculated. This is also the case where an exemption is available with respect to some types of foreign source income, but a foreign tax credit is available with respect to other types. The issues are similar to those mentioned in section 2.1 in the context of exemption with progression. In the context of progressive rates, the issue is whether foreign source income, for which foreign tax credits

subject to highest tax rates (top-slicing). Bottom slicing increases the likelihood that the limitation on credit will be engaged.

With the exemption method, only one slicing rule is required in applying exemption with progression (see Box 1). If the limitation on credit under a foreign tax credit system is calculated in any manner other than a worldwide limit, then the system will require multiple slicing rules to match the number of times the limitation on credit may be calculated. For example, if a country-by-country limitation is

between Country A and Country C under which Country C applies the exemption method to the Country A business income. ere is no tax treaty between Country B and Country C, but Country C unilaterally o ers a foreign tax credit where the limitation on credit is calculated on a slice-by-slice basis. Country C permits the resident to choose which slice of income is taxed at which rate (discretionary slicing rule).

Country A tax	
Business income	100
Source tax at 30 per cent	30

Income net of foreign tax	70
Country B Tax	
Immovable property income	60
Source tax at 25 per cent	15
;` fVdVef [` Ua_ W	&'
EagdUWfSj Sf #' bWdUWf	&

Income net of foreign tax	81
Country C tax	
Wage income	100
20 per cent on rst 150	20
5ag` fdk 4 [` fVdVef [` Ua_ W(YdaeeWgb)	&'
20 per cent on rst 150	8
>Vee XadMjY` fSj UdVf[f	&

@VfdVe[VWUVfSj	&
Country B immovable property income (grossed up)	60
20 per cent on rst 150 (that is to say, 10 a er wages and interest)	2
&' bWdUWf dVef ((" ^Vee #' [e' ")	$'
Less foreign tax credit	15

Net residence tax	7
Country A business income (grossed up)	100
Exemption	-

@VfdMgd ()" *# #'" ŽS$" Ž&Ž))	S"

e resident has saved 10 Country C tax by ordering the slicing to ensure full creditability of Country B tax under the foreign tax credit system and that the exempt Country A income is subject to the highest tax rate in Country C. e total tax paid (80 from all countries) is less than if all the income were derived from Country A (90 being 20 per cent of 150 b^ge&" bVdUVf aX#")ž

Further complications may be caused by the interaction of the schedular nature of tax treaties with the domestic tax base of the residence country. Tax treaties adopt a schedular approach in granting source country taxing rights (that is to say, under Articles 6 to 21). O en domestic tax laws also adopt a schedular approach, calculating and taxing di erent types of income di erently. Two schedular systems (treaty and domestic), applying to the same income, are unlikely to be the same and this can have consequences especially in calculating the limitation on credit, especially where a type of income limitation is adopted. is can result in the need for apportionment rules in allocating foreign tax to particular types of income as determined for domestic law schedular purposes.

Box 6oxA2(i)7(d)-2(en)9(c)-9(e t)-122(5)-8(0)523(n)

application of the foreign tax credit method. If the withholding tax is a nal tax, then it may be possible for the withholder (agent) to reduce the amount of domestic tax withheld by the amount of any foreign

As noted above, tax treaties often identify which foreign tax qualifies for a foreign tax credit, that is to say, taxes covered by the treaty (Article 2). By contrast, unilateral foreign tax credit systems have to identify which types of foreign taxes are sufficiently similar to the residence country income tax to qualify for a foreign tax credit. This can mean that unilateral foreign tax relief is broader than tax treaty relief and raises issues as to which relief applies. As a general rule, domestic law often permits taxpayers to choose between tax treaty and unilateral relief, especially where unilateral relief is more generous.

The tax year of the source country may be different from the tax year of the residence country and the timing of tax instalments and final tax payments can vary dramatically. A foreign tax credit system needs to relate foreign tax paid to a particular tax year. It may do this by associating the foreign tax with particular foreign source income or simply by granting a foreign tax credit for foreign tax paid within a particular year. These sorts of details are not covered by tax treaties and again are typically dealt with in domestic law.[25]

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[25] For example, see paragraph 32.8 of the Commentary on Article 23 of fZWA756 ? aVWV5a` hWf[a` ł dWbdaVgUW [` bSdSYdSbZ #&aXfZW5a_ _ W-tary on Article 23 of the United Nations Model Convention.

Finally, as with exempt foreign source income, there are issues as to how the foreign tax credit method interacts with the application of domestic loss relief. If losses (foreign or domestic) reduce foreign source income for which a foreign tax credit is available, then the limi-

credited by the residence country. e residence country simply cred-

2.3 Deduction of expenses

Whether a residence country adopts the exemption method or the credit method and whether it does it by tax treaty or unilaterally, it will need rules for allocating expenses between foreign and domestic source income. In the case of the exemption method, this is needed to ensure that expenses incurred with respect to exempt income do not reduce taxable income. In a foreign tax credit system, this apportionment is needed in order to appropriately apply the limitation on credit. is is particularly important where the foreign tax would otherwise exceed the domestic tax liability on the relevant foreign source income. It is common for an amount of cross-border income to be calculated di erently by source and residence countries and questions about the deductibility of expenses are o en the cause of this.[28]

Again, the allocation of expenses by a residence country between domestic source income and foreign source income, or between foreign source income and other foreign source income, is the sort of detail that tax treaties do not generally deal with. While tax treaties regulate to some extent deductions claimed in the source country (for example, under Article 7 and its Commentary)[29] they have virtually no impact

[28] Generally, regarding residence country allocation of expenses between foreign source income and domestic source income, see Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Alphen [illegible] *International Commercial Tax* [illegible]

[29] ere are substantial di erences of opinion even here, as evident in the di erences between Article 7 of the United Nations Model Con[illegible]

on the deductibility of expenses in the residence country. In principle, it is not contrary to a tax treaty for a residence country to discriminate against residents deriving foreign source income, whether by reason of application of tax rates, denial of concessions available with respect to domestic source income or the non-deductibility of expenses.[30]

As a matter of domestic tax law, the allocation of expenses by residence countries to foreign source income is o en not very detailed. In general, there are two extreme approaches that a residence country may adopt and these re ect approaches to allocation of income between countries.[31] At one extreme, a country may adopt a transactional approach and seek to determine the extent to which a particular expense is incurred in deriving the foreign source income in question. Some expenses will be di cult to attribute, such as interest on a loan where there will be a need to trace the use of the funds borrowed in order to determine an appropriate allocation of the interest expense, in some cases a near impossible task.

At the other extreme, a residence country may adopt some form of overall apportionment approach for allocating expenses to foreign source income. For example, expenses may be allocated to particular income-earning activities based on turnover or a mixture of factors such as assets, payroll and sales.[32] As with a formulary apportionment process to income allocation, the apportionment formula may be very general (for example, one factor) or may become increasingly

[30]As discussed in section 1.3.1, the non-discrimination rules in Article [illegible]
discrimination against deriving fotier[illegible]

itemized until eventually the transactional approach is approximated. O en countries adopt a mixed approach. For example, it is common for expenses that are easily identi ed as directly related to particular income to be allocated to that income (for example, cost of assets), whereas more general expenses are allocated on an apportionment basis (for example, overheads). Generally accepted accounting practice can be particularly important in the allocation of expenses for tax law purposes, but is not always determinative.

Box 10

Allocation of expenses

A resident of Country B derives 200 gross business income (for example, sale proceeds); 100 from a PE in Country A and 100 from Country B. e resident incurs expense of 20 in renting business premises in Country 3 S` V &" [` dWf[`YTge[`Vee bdW_ [eVe [` 5ag`fdk 4ž WdVe[VVf S^ea incurs 80 interest expense on funds borrowed to nance the business (in both countries). Country A uses a tracing approach to allocate expenses and so allocates 20 rent and 30 interest to the PE situated there. Country A taxes business pro ts at the rate of 20 per cent. Country B allocates expenses based on gross business income and so allocates 30 rent and &" [` fWdWef fa fZW5ag` fdk 3 B7ž5ag` fdk 4 fSj VeTge[` Vee bda feSf fZW rate of 30 per cent.

Country A tax

Business income (100 less 20 rent and 30 interest)	50
Source tax at 20 per cent	10

;` Ua_ W WfaXXadW[Y` fSj	&"

Country B tax

Business income (200 less 60 rent and 80 interest)	60
Residence tax at 30 per cent	18
Less foreign tax credit (limited to residence tax of 9; being 30 per cent of 30 (#" " Vee %" dWf S` V &" [` fWdWef))	+

Net residence tax	9

Where expenses related to foreign source income exceed that income, the result is a foreign loss. Foreign losses have an intricate interplay with systems for the elimination of double taxation.[33] Many countries feel a need to quarantine foreign losses so that they cannot offset domestic source profits. Just as tax treaties do not extend to the allocation of expenses in the residence country, they do not extend to the treatment of losses from foreign activities. Domestic law of the residence country will determine the extent to which such a loss may be set against domestic source income or against foreign source income from other foreign activities.[34]

Countries that adopt the exemption method with respect to particular foreign activities (for example, a foreign PE) often refuse to recognise losses from such activities. However, a few countries do allow such losses to reduce domestic source income, but on the condition that when the activities turn profitable those profits are not exempt to the extent that foreign losses were previously taken into account. This is commonly referred to as clawing back the benefit of the earlier use of the losses or reintegration of the loss.[35]

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[33]Generally regarding foreign losses, see Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: Structural Analysis*, supra footnote

Box 11

Exemption — Claw back of foreign losses

In year 1, a resident of Country B incurs a loss of 100 in business activities conducted through a PE in Country A. During that year, the resident also derives 100 business income from Country B. Country B taxes the resident at the rate of 25 per cent, but permits the use of foreign business losses against domestic business income. In year 2, the resident derives 100 business income through the Country A PE. e resident also derives 100 business income from Country B. Country A taxes business income at the rate of 20 per cent. Country B exempts the pro ts of a foreign PE, but reduces the exemption by any losses of the PE claimed in previous years.

Year 1 – Country A tax	
Country A business loss (available for carry forward)	(100)
Year 1 – Country B tax	
Country B business income	100
Less country A loss	(100)

Net country B tax	-
Year 2 – Country A tax	
Country A business income	100
Less Country A loss carried forward	(100)

Net Country A tax	-
Year 2 – Country B tax	
Country B business income	100
Country A business income (loss claw back)	100
Residence tax at 25 per cent	50

Net return	150

In year 1, Country B permits the Country A loss to reduce Country B source income even though Country B would exempt any pro ts if the

foreign activities were profitable. In this way, the foreign loss reduces Country B tax on Country B source income. However, when the foreign activities turn profitable, Country B denies an exemption for the foreign profits to the extent foreign loss relief was granted in previous years. In effect, the year 1 Country B tax on Country B source income is deferred to year 2. The foreign loss causes only a temporary erosion of the Country B tax base.

For a foreign tax credit country, it is natural that foreign losses are recognized. The question for such a residence country is whether those losses can only be carried forward for use against profits from the same foreign activity (quarantined), or whether they may be used against income from other sources, whether domestic source income or foreign source income. At some level, it might be suggested that the same approach should be followed as used in the foreign tax credit system, for example, type of income, country-by-country or worldwide approach. This would suggest, presuming an ordinary foreign tax credit is adopted, that foreign losses should not be available to reduce domestic source income. However, in practice, many countries do allow that to happen. One reason is that the relief provided is often clawed back automatically under the foreign tax credit method in the future if the foreign activities turn profitable.[36]

Box 12

Foreign tax credit — Quarantine of foreign losses

In year 1, a resident of Country C incurs a loss of 100 in business activities conducted through a PE in Country A. The resident also derives 50 business income from Country B and 100 business income from Country C. Country B taxes the business income at the rate of 30 per cent and Country C taxes at the rate of 25 per cent. In year 2, the resident derives 100 business income through the Country A PE. The resident also derives 50 business income from Country B and 100 business income form Country C. Country A taxes the business income at the

[36] This happens if the losses are carried forward in the source country. Future source country income is exposed to full residence country taxation without a foreign tax credit when that income is sheltered from source country taxation by the losses.

Many countries permit, through one mechanism or another, the losses of one member of a corporate group to o set the pro ts

corporate income when derived and again when distributed). As mentioned, the Model Conventions do not deal with this form of economic double taxation, especially from the residence country's perspective.[39] In particular the non-discrimination rule (Article 24) does not prevent a country from applying dividend relief to domestic source dividends while applying economic double taxation (classical system) to foreign source dividends. In practice, many tax treaties do provide relief from economic double taxation of corporate distributions in the residence country.[40] This relief is usually limited to dividends paid with respect to direct investment, that is to say, parent corporations in receipt of dividends, and for this purpose a definition of direct investment is required, which may, but likely will not, reflect the definition for lower source country taxation of dividends in Article 10 (2). Similarly, many residence countries unilaterally provide relief from economic double taxation of foreign source dividends.

Whether the relief from economic double taxation of foreign dividends by a residence country is provided under a tax treaty or unilaterally, it usually takes the form of the exemption or credit method, in the latter case referred to as an underlying or indirect foreign tax credit. The general issues dealt with above regarding each of these methods also apply in the context of providing underlying relief, for example, allocation of expenses, forms of limitation on credit, and identification of creditable foreign tax. However, underlying relief raises additional issues.[41] If its availability is limited to parent corporations, then the type and level of shareholding required must be specified. Commonly, this can be as low as 10 per cent, but much higher shareholdings are also used. There are issues as to whether only direct shareholdings count, or whether shares held through other related corporations count towards determining if the threshold is met, that is to say, indirect holdings are also counted.

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[39] There is a limited measure for relief of economic double taxation of parent corporations in Article 10 (2) from a source country's perspective.

[40]

be obtained through strategic distributions within a corporate group, that is to say, through the use of mixer corporations.

5ag` fdk 3 V[h[VWV	&*
Country B tax (participation exemption)	-

Income net of Country B tax	120

Country C tax — Parent

Country B dividend (%&aXEgT #e dMVS[` W bda fe)	+"
9daeeŽgb (%&aXfSj a` EgT #e [` Ua_ WfZSf [e fa eSkl %&aXS* 5ag` fdk 4 fSj a` Tge[` We [` Ua_ WS` V %&aX#$ 5ag` fdk 3 fSj a` bda fe g` Wdk[` YfZW V[h[VWV aX&*)	%'

Taxable income	120
Country C tax at 25 per cent	30
Less foreign tax credit	30

Net Country C tax	0

@WfdMVgd (%$ [` EgT $ (*" Ž&*)1 30 in Sub 1 (120 - 90) and 90 in Parent)	152

Sub 2 has distributed su cient pro ts to Sub 1 so as to mix pro ts held by Sub 1 to an e ective tax rate of 25 per cent. is ensures that when Sub 1 distributes pro ts to Parent the foreign tax credit is equal to the Country C tax. Because Country C has no characterization look-through rules, it only sees one slice of income, that is to say, a dividend, and not the investment income and business income that make up the pro ts from which the dividend is distributed. is avoids Country C's slice-by-slice limitation on credit, which would have been engaged e.6E56(c)-9(e)r/Actua/A3(c) inveness iatnly sees one slb(b 1 o t)-31(h)5(e C)-18(o)9(u)-23(n)15(t)-23(r)-38(y)5( )]TJ

If tax treaties deal with underlying foreign tax relief for foreign source dividends, the provisions are usually limited to direct investors.[44] However, there is an increasing trend, particularly in European countries, to grant more arbitrary forms of dividend relief to non-corporate shareholders generally and extend this relief to foreign dividends. The relief often takes the form of a limited dividend exemption or, more commonly, a lower tax rate applied to dividends (for example, see Box 7).[45]

3. Administering anti-avoidance rules

As noted above, tax treaties have two primary purposes — elimination of double taxation (section 2) and the prevention of fiscal evasion. The latter topic is considered specifically in another chapter,[46] but it is useful to make a few comments at this stage in the specific context of residence country taxation of foreign source income. As mentioned, much of that taxation is not regulated by tax treaties directly. Nevertheless, residence country taxation of foreign source income is just as prone to tax planning, tax avoidance and tax evasion as the taxation of domestic source income. There are two aspects to this. The first is whether anti-abuse rules that apply generally also apply to the taxation of foreign source income. The second is whether the nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance.

&&During the 1970s to 1990s, there was a tax treaty practice by some European countries to grant dividend tax credits available to resident shareholders to treaty partner shareholders, especially portfol

3.1 Application of domestic rules

Income tax laws commonly contain di erent types of anti-abuse rules. ese might address speci c issues, such as excessive debt nancing, transfer pricing, sale of loss corporations, use of service corporations, hidden pro t distributions, dividend stripping, income splitting or assignment of income, etc.[47] Income tax laws also commonly incorporate, or are subject to, a general approach to tax law abuse, such as a general anti-avoidance rule or substance over form doctrine. From a domestic law perspective, such anti-abuse rules typically apply to the taxation of foreign source income in the same manner as they apply to the taxation of domestic source income.[48] Further, as a general rule, because tax treaties do not limit the scope of a residence country's right to tax foreign source income, they do not restrict the application of domestic anti-abuse rules to foreign source income.

3.2 Rules targeted at foreign source income

e nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance. ese are broadly of two types—those that manipulate whether the residence country is required to provide foreign tax relief, and those that manipulate the time at which foreign income is recognized by the residence country and so subject to tax. e former is o enevio pt lnilehe rotp-

view that the taxpayer does not have a PE situated in that country but the residence country does so. This can result in no source country taxation, but the residence country nevertheless seeking to relieve the (non-existent) double taxation by exempting the profits of the taxpayer's activities in the source country (mismatch of PE characterization).[49] Another example is where the taxpayer may elect to be taxed in the source country (and does so) so as to meet a "subject to tax requirement" for claiming an exemption in the residence country.

The foreign tax credit method can also be abused. The use of mixer corporations to avoid limitation on credit rules was mentioned above (see Box 13). Source countries have sometimes participated in the manipulation, such as where they grant designer tax rates so as to maximize relief in the residence country. The scope of the relief may also be abused, such as where the residence country provides underlying foreign tax credits for a payment that is deductible in the source country. Here the potential for abuse may not be as great as under the exemption method, but residence country tax savings may still be pursued.[50]

Historically, the biggest problem for residence country taxation of foreign source income has been deferral of that taxation by retaining the income in a foreign corporate tax shelter. As corporations are separate legal entities and typically separate taxpayers, the controllers of a corporation (often high-wealth, high-tax rate individuals) can cause the 2 Tdu[(o)12(f)1(a)1(c)-2(o)12(r)-23(p)-(4b)12(r)-8(a)12(r)-23(p)-(4b)12(r

possibility of retaining the profits of their controlled corporations in tax havens where they are subject to little or no taxation.[51]

As a response, numerous countries have enacted controlled foreign corporation rules. These rules can be complex, but their general thrust is to tax resident shareholders on their proportionate share of profits of a non-resident corporation (whether the profits are distributed or retained) that is controlled by residents. At a conceptual level, controlled foreign corporation rules are an example of the tax law lifting the corporate veil. As usual with residence country taxation,

For many years, the largest group of target shareholders subject to anti-deferral rules has been corporate shareholders, particularly parent corporations of controlled foreign subsidiaries. The rationale for taxing such corporations immediately on the profits of their subsidiaries was in order to prevent the avoidance of residence country taxation.

However, at a conceptual level, the taxation of corporations is a method of taxation at source, particularly the taxation of the corporation's shareholders. From this perspective, the application of controlled foreign corporation rules to parent corporations is a method of preventing deferral of residence country taxation by the parent corporation's shareholders. Increasingly, resident corporations are not owned solely by resident shareholders, at least not taxable ones. Indeed, there are many corporations, particularly widely held corporations, which are majority owned by tax exempt institutions (such as pension funds) and non-resident persons (including sovereign wealth funds).

In a globalizing world, with increasing fragmentation of shareholders, there is evidence that the application of controlled foreign corporation rules is having an increasing effect on the location of the parent corporation's residence. Application of controlled foreign corporation rules by residence countries makes less sense if a parent corporation's shareholders are not subject to residence country taxation in the same jurisdiction as the parent corporation. In the future, residence countries that wish to address the deferral issue may find that they need to target their anti-deferral rules more precisely at the persons (often high-wealth resident individuals) that are subject to residence country taxation.

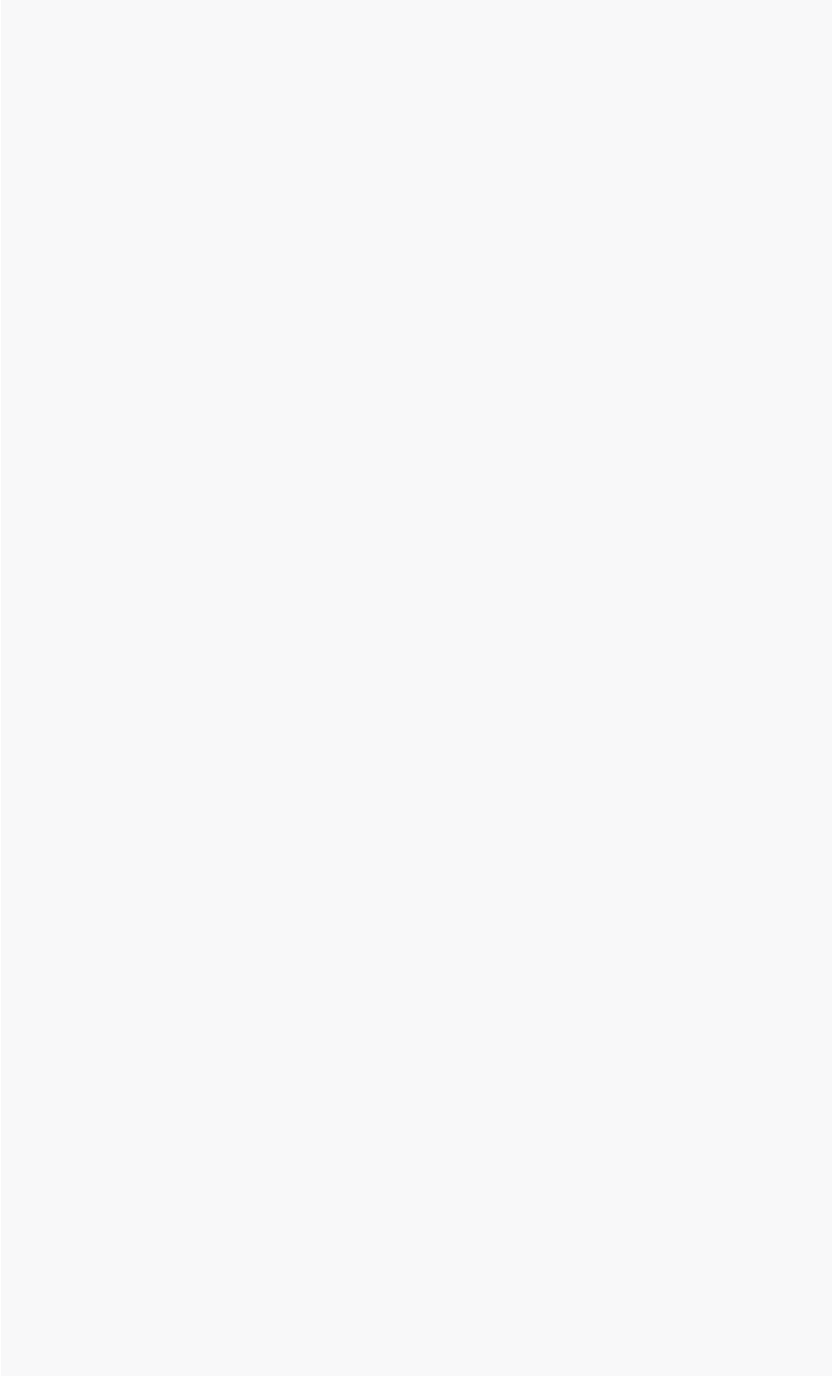
4. General issues in administering the taxation of foreign source income

There are four core areas of tax administration — collection of information, assessment, dispute resolution and collection of tax.[53] Thus far,

[53]Generally, regarding tax administration with respect to cross-border taxation of income, see Peter A. Harris and David Oliver, *International Commercial Tax* [illegible] these four areas, see OECD (2013), *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*, particularly at pp. 289-329.

the focus has been on the rules (especially tax treaty rules) that must be used in making an assessment of tax due to the residence country with respect to foreign source income. However, issues pertaining to tax administration procedure, and whether there are any particular issues, regarding these core areas of tax administration raised by residence country taxation of foreign source income, have not been con-

In addition, further information will be required because of the nature of the income as foreign source income and the effect of the treaty provisions previously mentioned. In particular, most residence countries treat foreign source income differently, depending on the country from which the income is derived, and this is particularly a



4.1.2 Forced disclosure

As a resident taxpayer is within the jurisdiction of the residence country tax administration, there are no legal restraints on requiring the resident taxpayer to declare foreign source income (as mentioned STahW[` eWUf[a` &ž#ž#) fa fZWfSj SV_[`[efdSf[a` S`V VW_S`V[`Y fZSf the return be supported with relevant documentation. Failure by the resident taxpayer to declare required information will be met with a penalty under the domestic law of the residence country. As a general rule, most countries collect such penalties in the same manner as taxes, S`V [` fZ[e dWYSdV fZW S`S'ke[e [` eWUf[a` &ž& [e dWWhS`fž: ai WhWd S tax administration will not know whether to impose such a penalty unless it can independently verify that the requirements as to declara

Even if a particular tax administration has domestic power to request assistance from a foreign tax administration in the forced collection of information, it is unlikely that (in the absence of a treaty) the foreign tax administration could comply with the request. is is because the foreign tax administration will have been established for the purposes of administering local taxes (not foreign taxes) and its powers, including its information gathering powers will have been granted exclusively for that purpose. is means that in almost all cases the foreign tax administration will have no domestic legal power to collect information for the enforcement of foreign tax laws.

erefore, when it comes to enforcing residence country tax consequences of a resident taxpayer deriving foreign source income, li -ing these limitations on the exchange of information with the source country tax administration is critical. e potential for this exchange and easing these limitations is facilitated by tax treaties and, in particular, Article 26. Article 26 (1) permits the competent authorities of the treaty partners (typically the tax administrations) to exchange information "as is foreseeably relevant for carrying out the provisions" of the treaty. It also permits exchange for the "administration or enforcement of domestic laws concerning taxes of every kind and description", whether imposed by the treaty partners, their political subdivisions or local authorities. Accordingly, the power to exchange information is substantially broader than the taxes covered by the distributive rules of tax treaties. Further, there is no requirement that the person with respect to whom the information is requested be a resident of either contracting State.[54] e United Nations Model Convention provides for the competent authorities to develop procedures for exchange of information through consultation.[55]

Exchange of information typically takes one of three di erent forms.[56] It may be provided to comply with a request of the competent

[' &]For example, see paragraph 8.2 of the Commentary on Article 26 of the United Nations Model Convention.

[55]Article 26 (6) of the United Nations Model Convention.

[56]8adVjVS_ b'WeVWbSdSYdSbZ' %&aXfZW5a_ _ WfSdka` 3df[UW$(aXfZW United Nations Model Convention and the Inventory of Exchange Mechanisms at paragraph 30. In 2006, the OECD published a Manual on Information Exchange, available at http://www.oecd.org/ctp/exchange-of-tax-information/cfaapprovesnewmanualoninformationexchange.htm.

authority of the treaty partner. Some information may be provided automatically and this is particularly the case with computer-generated records. irdly, the competent authority may provide information on its own initiative, that is to say, spontaneously, such as where it feels that the competent authority of the treaty partner may view the

ceed with a dispute in the court system of the residence country (or that of the source country). However, many tax administrations are

provision that gives e ect to a mutual agreement even if it is contrary to a court decision, but, in others, the internal law does not permit the mutual agreement to override a court decision. e normal procedure would be for the mutual agreement to bind the tax administration, but not the taxpayer, much in the same manner as a tax rulings system. is would leave the taxpayer open to challenge the agreement in the courts. To prevent any potential inconsistency, it is common for implementation of a mutual agreement to be subject to acceptance of the agreement by the taxpayer and settling of any court proceedings.[65]

Most commonly, the mutual agreement procedure is used in tgr-21(u)-26

adjustment (see section 1.3.2) required of the residence country under Article 9 (2) is a common subject of the mutual agreement procedure. Another common subject for mutual agreement is determination of the appropriate article under which a source country can tax. As source country taxing rights vary depending on which article of a tax treaty is applicable, this will also have an e ect on a residence country's obligation to eliminate double taxation.

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of f cials of the competent authorities. The taxpayer is not bound by an
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4.4 Collection of tax

Finally, at least when the assessment or tax decision is not disputed (or not capable of dispute), there is the issue of collecting tax or enforcing the decision. Here again, there are usually two mechanisms. ere is collection directly from the taxpayer and the taxpayer's assets. Secondly, the tax laws of most countries also provide for situations in which recovery may be from a third party, for example, a person owing

[67]Article 25 B (5) of the United Nations Model Convention and Article 25 (5) of the OECD Model Convention. Alternative A of Article 25 of the United Nations Model Convention does not contain an arbitration provision.

[68]See paragraph 76 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 18 of the Commentary on Article 25 of the United Nations Model Convention.

money to the taxpayer, such as a bank. Like other powers of the tax administration, the power to collect taxes and the mechanisms that may be used are a matter of domestic law.

In the context of foreign source income of residents, o en the residence country has the taxpayer and local assets physically within its jurisdiction for purposes of enforcing a tax assessment. However, there will be cases where a resident person has few assets in the jurisdiction and the person is not physically available for enforcement, for example, in cases of arti cial entities or where an individual has taken ight. Here the general position is the same as described in section &ž# [` fZWUa` fVJf aXUa^Wf[a` aX[` Xad_ Sf[a` ł fZSf [e fa eSk [ddWebW- tive of what the domestic law of the residence country provides, its tax administration will not be able to collect its taxes in a foreign country. Further, in the absence of legislative authority, most tax administrations are not empowered to collect the taxes of a foreign country requesting assistance.

Article 27 of both the United Nations and OECD Model Conventions provides for mutual assistance of competent authorif[We [` fZWUa^Wf[a` aXfSj Weź>[] W3 df[UW$&a` `a` ŽV[eUd[_ [` Sf[a` and Article 26 on exchange of information, Article 27 is not limited to taxes covered by the distributive rules of the particular treaty. While an assisting tax administration will continue to use its domestic tax collection powers when providing assistance, the competent authorities are to settle by mutual agreement the mode of application of the Article.[69]

Article 27 (3) provides for a competent authority to request of the other competent authority assistance in the collection of a revenue claim. A request may be made only if the taxpayer cannot "prevent" the collection of the claim under the laws of the requesting country. e other competent authority is then to collect the claim "in accordance with the provisions of its laws applicable to enforcement and col^Wf[a` aX[fe ai ` fSj WeŒŠž3 df[UW$) (& _ S] Wee_ [^Sdbdah[e[a` Xad assistance in preemptive measures in the collection of revenue claims,

[69]In 2007 the OECD published a Manual on Implementation of Assis-

referred to as "measures of conservancy". Under Article 27 (8), a contracting State is not required to assist unless the requesting State has "pursued all reasonable measures of collection … under its laws or administrative practice …" or where the "administrative burden … is clearly disproportionate" to the taxes to be collected.

Under Article 27, a residence country seeking to collect tax with respect to foreign source income of its residents may request assistance with that collection of the source country. However, Article 27 is general in nature. e residence country may make such a request of any country (with which it has a treaty with a provision on assistance in collection) that may be able to provide that assistance, such as a country where the person has substantial assets.

Chapter IV

Taxation of non-residents

Colin Campbell*

1. Introduction

1.1 Scope of the chapter

is chapter considers the issues faced by developing countries where a person, who is not resident for tax purposes in a State (a non-resident) under the domestic law of that State (the source State), has activities either in, or with residents of, the source State, which attract tax liability under the tax law of that State, and is a resident of another State with which the source State has a bilateral tax treaty. For these purposes, only taxes on income addressed in tax treaties[1] will be considered. e issues arising in these circumstances include determining if the non-resident is entitled to bene ts under the treaty and, if so, how these bene ts are delivered, whether by refunding to the non-resident amounts paid or withheld in excess of the treaty-mandated amounts, or by reducing amounts paid or withheld to re ect reduced rates of tax provided under the treaty. A further issue, unrelated to the collection of tax from non-residents, arises out of the mutual obligations contained in most, if not all, tax treaties on each contracting State to provide to the other State information relevant to the administration of the tax system of that State and, in some cases, to provide assistance in the collection of taxes.

e following types of income will be considered:

1. Passive investment or portfolio income derived from the holding of property giving rise to interest, dividends or royalties paid by a person or entity in the source State.
2. Income from a business of providing services, whether or not attributable to a xed base or permanent establishment of the non-resident in the source State.
3. Income from carrying on other businesses, whether or not attributable to a permanent establishment of the non-resident in the source State.
&ž ;`Ua_ WXda_ bdah[V[` YeWdh[UWeSeS` W_b^akWWi Z[UZ SdW exercised in the source State.
5. Income from gains realized by the non-resident in the source State.

e application of tax treaties to some of these types of income is discussed in detail in other chapters of this Handbook.[2]

1.2 Ensuring compliance with domestic tax law by non-residents generally

For the purposes of this chapter, 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. Typically, these measures will have three principal elements:

(a) Identi cation of non-residents:

e rst step in taxing non-residents on income derived from the source country is the identi cation of such non-residents. is identi cation requires the source country to have good information and depends on the type of income derived. Where

[2]See chapter V, Taxation of non-residents on business pro ts, by Jinyan Li; chapter VI, Taxation of non-resident service providers, by Ariane Pickering; and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

the income-earning activities consist of carrying on business

required to le a tax return in which the pro t of the business and the amount subject to tax is calculated and supporting

are two arguments against that view. In the rst place, such withholding regimes are widely, if not universally, used in developed countries and are thus not unfamiliar to potential investors. Secondly, the undoubted bene ts 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. ere is therefore a major role for source withholding in ensuring both reporting and payment.

e use of nal withholding taxes to collect tax from non-residents is widespread and recognized internationally as a legitimate mechanism to collect tax. It should be noted, however, that such taxes are a proxy for a tax on the net income derived by non-residents and may not be appropriate where a non-resident incurs substantial expenses in earning the income. e rate of withholding is obviously critical. In some circumstances, non-residents may be able to require the resident payers to bear the burden of the withholding tax by “grossing-up” the amount of the payment. us, the withholding tax could have the undesirable indirect e ect of increasing the cost of nancing, technology and services to residents of the source country.

1.4 Effect of tax treaties

Tax treaties do not generally impose restrictions on the administrative policies or procedures of a contracting State.[6] Accordingly, the source State should that s7(h)12([(s)2727(u1 29)411(.)15(c)-(g)-F24 Tw-7(s d)7(o

contracting State. In some cases, income otherwise taxable will be exempt from tax under the treaty (for example, business profits not attributable to a permanent establishment). In other cases, the rate of tax will be limited under the treaty (for example, tax on interest, dividends or royalties). This places additional administrative burdens on the source State, namely 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 reflect reduced treaty rates of tax or for making timely refunds where tax has been withheld at higher than the treaty rate. As a result, the non-resident may be subject to different or enhanced reporting to allow the tax authorities to effectively apply the treaty.

The remainder of this chapter 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. Registration requirements for non-residents

Many countries use taxpayer identification numbers for residents in order to make the assessment and collection of tax more efficient. Such numbers can also be used for non-residents and, in particular, those who are carrying on business in a country. The assignment of a taxpayer identification number can be part of the business registration of non-residents.

The obligations imposed by a tax treaty on a source State to give non-residents such favorable 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 salaries or wages, dividends, interest, royalties and other amounts 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. Registration could require non-residents to provide 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 status, the registration document may not disclose the actual residence of the non-resident, nor contain information necessary to determine whether the residence of the non-resident constitutes residence for treaty purposes. It is doubtful that the

are exempt from source-State tax, the most difficult situations may involve sales of real property disguised as sales of personal property, for example, shares of a corporation whose value derives principally from real property. Where such gains are taxable in the source State, identification and collection of tax may be problematic. It is obviously important that the treaty apply to such situations, as is the case under 3df[UW#%(& S` V(') aXfZWG` [fW@Sf[a` e? aWW5a` hWf[a` ž

3. Appointment of local representatives or agents

The appointment of a local representative or agent by a non-resident of a treaty State may assist in the reporting and collection process because such persons can be required, under domestic law, to report relevant information and transactions and to withhold where payments to the non-resident are made through the agent or representative. While general reporting and withholding obligations may (and should) be placed on all payers in the source State, agents and representatives of the non-resident are likely to be more knowledgeable about the relevant facts and less able to avoid responsibility. Where appointments of such agents or representatives are required for 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 for the purposes of an applicable treaty 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 risk of revenue

4. Procedures for claiming treaty benefits under various methods of assessment and collection

4.1 Filing tax returns

Domestic tax law provisions would normally require the ling of a return where tax is imposed on a net amount that must be calculated and reported in the return. is would include business income of all kinds and, in most cases, capital gains where the cost basis and expenses of sale may be relevant in computing the amount subject to tax. In tax systems where deductions are allowed in computing employment income, returns will be required to report net employ-

in the other State. Although residence certi cates issued by the tax authorities of the other country are useful, they should not be treated as binding on the source country.

In the case of interest, dividends and royalties, the non-resident must also demonstrate bene cial ownership of the amounts in question.[9] While bene cial ownership may also be the subject of an information request to the tax authorities of the other State, an independent investigation may be necessary because that State may use a di erent de nition of bene cial ownership for these purposes. Facts relevant to the determination of bene cial ownership, 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 bene t 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 bene t 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 miued. Fed aes-15(m)-13(i3)-17(ha)10(t t)-2(o)1(s)-5(e)6(i)-17(5(

payments should also be reported to the tax authorities. Consideration could also be given to requiring major contractors on such projects to report payments made to subcontractors who are, or appear to be, non-residents. Withholding rates could be set sufficiently high to create a real incentive for non-residents 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, except where the employee is employed by a non-resident employer without any permanent establishment in the source country, in which case the employee will be exempt from source-country tax if the employee is present in the source country for 183 days or less.[11] Otherwise, under a typical treaty, non-resident employees will be taxed wholly or largely in the source State on their income from employment exercised in that 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.

4.2 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 or exemption. The application for such a waiver or ruling is subject to the same issues as the assessment of treaty claims in a tax return and the same information or evidence should 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, which is ultimately filed. Such an application raises the same issues of demands 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.

[11] Article 15 (2) of both the United Nations and OECD Model Conventions.

4.3 Information provided to resident payers

As an alternative to providing administrative waivers or rulings, the source State might rely on resident payers to request information from non-resident recipients 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 is satisfactory only if the resident payers are su ciently 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.

4.4 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 bene ts in a return. For the tax authorities the principal issue is ensuring that delay in processing claims does not adversely a ect investment in the source State.

5. Information gathering

5.1 TnyR BDC (.)TjyR BDC (.)TjyRtEEFs 0.01r(h)9(e11(o))-14ejyR Bsti

speci c provisions in the treaty, whether it can decline such requests on the basis of reciprocity, as noted above. Depending on the forbearance of the other contracting State, this lack of reciprocity may impair its ability to get information from the other State to police treaty-based claims by non-residents. Where a State believes such a situation is likely to arise, it may be preferable to deal with the issue directly, either in the course of the initial treaty negotiation or in negotiating subsequent amendments, by clarifying, either by protocol or diplomatic note, the mutual realistic expectations of the parties with respect to exchanges of information.

Any State assuming the treaty obligations with respect to the exchange of information must take steps to ensure that its domestic law provisions with respect to gathering and disclosure of information are broad enough to encompass its treaty obligations. In particular, bank secrecy is no longer an acceptable constraint on a country's ability to exchange information. Most countries have agreed to conform to the international standards on exchange of information, which is being implemented through the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Both the United Nations and OECD Model Conventions note that the wide-ranging provisions of Article 27 may not accord with the domestic law or the domestic administrative provisions or practice. It is specifically contemplated that in such cases the contracting States may choose not to include such an article in the treaty. In practice, provisions for assistance in collection are still relatively rare and vary widely from treaty to treaty and might be limited to recovery of amounts the payment of which was specifically contemplated in the treaty, or to recovery from tax residents of the requesting State who have assets in the requested State.

A State entering into a tax treaty should consider carefully the benefits and costs of including a collection assistance article in the treaty, given the potential administrative burden involved. This consideration would include some estimate of the amount of unpaid tax, which it might recover through the treaty.

6.2 Convention on Mutual Administrative Assistance in Tax Matters

The Convention on Mutual Administrative Assistance in Tax Matters[17] (sometimes referred to as the "Strasbourg Treaty") provides for exchange of information, assistance in collection and service of documents, in terms that are generally similar to the OECD Model Convention provisions. A State that is prepared to accept fairly substantial obligations with respect to exchange of information and assistance in collection might consider adherence to the Strasbourg Treaty as a more convenient method of dealing with a fairly large number of

in the other State to “any taxation or any requirement connected there-with, which is other or more burdensome” than such requirements applying to nationals of the other State in the same circumstances.

e administrative provisions discussed in this chapter should not be Ua`e[VWdWV fa TW V[eUd[_[`Sfadk g`VWd 3df[UVW$&(#) Xadfi a dWSea`ež In the rst 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 applica-ble to residents of the source State, not to non-residents. Furthermore, provisions applicable to non-residents, such as tax ling require-ments 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.

8. Anti-avoidance ruh e to r(fj/Span Actual (s)-53(n)1l)5(y)-382783 17
710((g a)-m)9(7)4(n)2ab s 3(n)10(d t)6(o)5( ) TJ-0.005 Tc 0.005 3(12 I)39(5(a),)1(m)9(o

standard of proof (likely on a balance of probability, but possibly differing in the domestic law) should neither be relaxed for the taxpayer, nor made more demanding for the tax authorities by the provisions of a treaty.

Chapter V

Taxation of non-residents on business profits

Jinyan Li*

1. Introduction

e taxation of non-residents on business pro ts is important to developing countries in terms of raising revenue and encouraging foreign investment and trade. e source country has the legitimate right to tax business pro ts arising in its jurisdiction. Tax treaties impose no limits on such taxing rights, other than the obligation to tax net profits (instead of gross pro ts) in some situations, once the threshold for taxation is satis ed. As such, this source of tax revenue belongs to the source country. ere is generally little expectation of the residence country of a non-resident taxpayer in sharing the tax revenue. It is true that the residence country also has a right to tax the pro ts, but it generally provides a credit for the source country tax or exempts them from tax in order to prevent double taxation. If the residence country provides a credit for taxes paid to the source country, the noncollection of the taxes owed to the source country is a scal transfer to the residence country, with no bene t to the taxpayer.[1]

e threshold for the source country to tax the business pro ts of non-resident taxpayers is the existence of a permanent establishment (PE) through which the business of the non-resident taxpayer is car(u)-8(g)(-)Tju018to t. If tss(t)-16d. -20(i)11(o)13(2(4h)20()-35(x)-11(a)10(t)-20(i)

foreign companies would presumably be encouraged to use a PE as opposed to a subsidiary when the pro ts attributable to a PE are not taxed as e ectively as pro ts of a subsidiary.

e manner in which taxes on business pro ts are collected and enforced, and the actual or perceived e ciency and fairness in dealing with non-residents may a ect the business environment. To non-resident taxpayers, taxes are part of the cost of doing business. Certainty and predictability in tax are perhaps as important as the amount of tax. erefore, competent tax administration can not only collect the taxes due, but also contribute to a positive business environment for foreign investment. On the other hand, if the tax administration is ine cient or incompetent, causing uncertainty, confusion or aggravation for taxpayers, it may discourage foreign companies from doing business or making investment in the source country.

e taxation of non-residents on business pro ts presents many di cult administrative issues because di erent types of business profits are subject to di erent thresholds for taxation, di erent sourcing rules and di erent methods of computation and collection. Unlike source-country taxes on investment income and employment income which are normally collected through withholding, business pro ts are g1(p)2(ah(g)-13(, b)13(u)-10(s)6(e nT12(r)9t)-27(h ah(g-19(h w)3b(1c-17(n)10

This chapter focuses on Articles 5 and 7 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries[2] (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[3] (OECD Model Convention).[4] A thorough discussion of the taxation of services (including the services of artistes and sportspersons) and investment income, which are important types of business profits, is covered under separate chapters.[5] The taxation of other types of business profits, such as transport and immovable property, is mentioned in this chapter to the extent that it is relevant to the understanding of Articles 5 and 7.

2. Tax information

Good information is the key to effective taxation of non-residents' business profits in the source country. The tax authorities of the source country need to know which non-residents are carrying on business in their country and whether the business is carried on through a PE. Such determination is highly factual and requires the tax authorities to have good information about the non-resident taxpayer's activities in the source country. Obtaining information from the non-resident or about the non-resident is often challenging. In many developing countries, there may be a serious information deficit.[6] This section briefly deals with ways of addressing such deficit.

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[2]United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[3]Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

[4]Unless specified otherwise, any references to Articles in this chapter are references to the Articles of the United Nations and OECD Model Conventions.

[5]See chapter VI, Taxation of non-resident service providers, by Ariane Pickering, and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

[6]Robert Couzin, "Imposing and Collecting Tax" in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation, 2003), at pp. 171-200.

2.1 What type of information?

e objective of obtaining information is to enable the tax administration to determine whether a non-resident taxpayer is carrying on business activities, meets the threshold for taxation, has revenues and expenses connected to the PE and whether the prices charged for deal-

Second, the format of information is as important as the content. Ideally, tax information should be in electronic format that can be used by the tax administration to make comparisons with other years, other taxpayers and other sectors, or to determine the impact of di erent cost allocations or transfer pricing models that in uence the pro t attributable to a PE. Standardization of the data sets and format are impf the data snats12(r)-15(ma)17wthe impact
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carrying on business in ailand, whether setting up a branch or an o ce, must apply for a tax identi cation number from the Revenue Department. e taxpayer must complete an application form[9] and provide some supporting documents, such as a copy of a company's registration license. e application form typically asks for information such as the name, address, local agent or representative, type and duration of the business. e registration requirement is not formally connected to the subsequent tax status of the non-resident taxpayer. e tax threshold is determined based on the facts, not merely on the registration. In practice, however, the tax registration may be a strong indication of a signi cant business presence in the source country.

Transaction reporting provides additional evidence that may be relevant to the taxation of non-resident taxpayers on their business pro ts in the source country. One type of transaction reporting relates to transactions between related enterprises, which is o en part of transfer pricing documentation. e report may cover the relationships, the organizational structure of the enterprise group, the type of transactions, etc. Another common type of transaction reporting relates to services rendered by non-residents. Such reporting is o en coupled with a tax withholding requirement.

Tax returns are required to be led by non-resident taxpayers, in certain circumstances, in accordance with domestic tax law. e return is o en the same for domestic and foreign enterprises and is

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Administration of Taxation Interim Provisions on the Administration of Taxation of Resident Representative O ces of Foreign Enterprises (Guo Shui Fa [2010] No.18, issued on February 20, 2010, the representative o ce must register within 30 days of the issuance of the registration certi cate with the

led annually. Non-resident taxpayers must also apply for treaty bene ts, o en in a prescribed manner.[10] e issue of "double thresholds" is worth mentioning. e threshold for taxing non-resident taxpayers is o en lower under domestic law than the PE test. is means that a non-resident taxpayer that meets the domestic threshold may be exempt from taxation if the business activity falls below the PE threshold. Nevertheless, the obligation to le a tax return is based on the domestic threshold. A non-resident taxpayer should disclose its treaty-based return position by declaring that its business activities are insu cient to meet the threshold for taxation in the source country under the applicable treaty. is information may be valuable as it permits the tax administration to examine the validity of the claim of treaty bene t and ags potential targets for audit.[11]

2.2.2 Withholding agents

Withholding is particularly e ective as a means of collecting income tax on many forms of business pro ts paid to non-residents (that is to say, dividends, interest, royalties and service fees). It is also an e ective and, arguably, the only practical, mechanism for gathering information from non-resident taxpayers who do not have a business presence in the source country. is is true whether or not the withholding tax is nal or provisional.

[10]See, for example, Canada Revenue Agency, Schedule 91, Information Concerning Claims for Treaty-Based Exemptions, available at http://www.cra-arc.gc.ca/E/pbg/tf/t2sch91/README.html (visited on 30 April 2013) and China, State Administration of Taxation, Administrative Measures for Non-tax Residents to Enjoy Treaty Bene ts (Trail) (the Measures), Guo EZg[8S N$[" " +O@až#$&ł 3gYgef $&ł $" " +ł ShS[ʹSTʹVSf i i i žŁZ[` SfSj žYahžU (in Chinese) (visited on 30 April 2013). A non-resident must submit the following supporting documents to the tax authorities to obtain a treaty-based tax reduction or exemption: (i) application forms; (ii) a resident certi cate issued by the competent authority of the treaty country or region; (iii) documents that evidence the taxpayer's right to the payment, such as property ownership certi cate, agreement, payment voucher, or certi cate issued by an intermediary or notary agent.

[11]See Robert Couzin, "Imposing and Collecting Tax" in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *e Taxation of Business Pro ts under Tax Treaties*, supra footnote 6, at p. 183.

Withholding agents often claim a deduction for the payments (other than dividends) in computing their own tax liability. Therefore, in addition to information returns filed by withholding agents regarding the payments to non-residents, the general corporate tax returns of withholding agents may reveal useful information about payments to non-residents in the form of interest and royalties which are deducted in computing the agent's profits.

2.2.3 Other government agencies

Other government agencies that administer corporation registration, intellectual property registration, industry regulation, foreign investment, customs and immigration, often have information relevant to the taxation of business profits earned by non-resident taxpayers. For example, in order to carry on business in Canada, a foreign corporation will need to register as an "extra-provincial corporation" in all the provinces in which it intends to do business.[12] In completing the registration process, the foreign corporation is required to designate an attorney resident in the province who can accept service of legal documents on behalf of the foreign corporation, and a "head office" of the corporation in the province through which business may or may not be conducted. Registration as an extra-provincial corporation does not, in and of itself, amount to a PE for income tax purposes. Similarly, in Australia, a foreign company must register with the Australian Securities and Investments Commission (ASIC).[13] It must file appropriate documentation, appoint a local agent and maintain a registered office and, in certain instances, a register of local members in Australia. Once the foreign company has been registered with ASIC, it must comply with various obligations, such as reporting its financial results to ASIC. Failure to register a foreign company in Australia is a

[12]See, for example, Ontario, Application for Extra-Provincial Licence Form 1 Extra-Provincial Corporations Act, available at http://www.forms.ssb.gov.on.ca/mbs/ssb/forms/ssbforms.nsf/FormDetail?openform&ENV=WWE&NO=007-07065 (visited on 30 April 2013).

[13]Australian Securities and Investments Commission, Application for Registration as a Foreign Company, available at http://www.asic.gov.au/ Se[U.bV [Tž eX>aa] gb4k8[ʼV@S_ V.&' $žbVX$ ʼV.&' $žbVX (h[e[fW a` %' April 2013).

strict liability o ence and could result in nes by ASIC and the courts. ere may be a registration requirement for certain industries, such as banking, insurance, mining, etc.

2.2.4 Exchange of information

e exchange of information (EOI) mechanism in tax treaties is useful to a source country in obtaining information about a non-resident from the non-resident's residence country.[14] e term "exchange of information" has a very broad meaning. It includes "an exchange of documents and an exchange of information unrelated to speci c taxpayers and the provision of information by one contracting State whether or not information is also being provided at that time by the other contracting State."[15] e obligation to provide requested information is for an "e ective" exchange of information, meaning that the requested State may not avoid its obligations under Article 26 through unreasonable time delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange.[16] e types of requested information are also broad. For example, in computing the taxable pro ts of a PE that is located in the source country and has its head o ce in the residence country, the source country may request information from the residence country about the expenses and pro ts of the head o ce and the dealings of the head o ce with other PEs and associated enterprises.[17]

Developing countries may not be reaping the full bene ts of the exchange of information mechanism for several reasons. For example, the source country may not have su cient information to know the right questions to ask the other country. It may not know if a non-resident enterprise is carrying on business in its country. In the case of

#&Generally, see chapter IX, Exchange of information, by Diane M. Ring.

[15]Paragraph 5 of the Commentary on Article 26 of the United Nations Model Convention.

[16]Paragraph 9 of the Commentary on Article 26 of the United Nations Model Convention.

[17]Paragraph 10.1 of the Commentary on Article 26 of the United Nations Model Convention.

automatic or spontaneous exchanges, the exchanged information may not be very useful in the absence of an integrated information system that can accommodate the volume of input and produce useful output. e level of information technology may vary greatly from country to country.

3. Identifying the non-resident taxpayer

3.1 Steps in applying treaty provisions

ere are two important steps in applying treaty provisions. e rst step is to identify the person who earns income in the source country and to determine where this person is resident for treaty purposes. e second step is to determine which treaty article might be applicable. is step is important because, as described below, several articles of a treaty may apply to the taxation (i)11(co)13(n tn-s)46(i)-17(n)10()-5(c)9(a)5(w)-3(

MNE is the taxpayer with respect to the business pro ts earned in the source country. As mentioned below, however, if the subsidiary acts as a dependent agent of its parent or the parent uses the premises of a subsidiary to carry on its own business in the source country, the parent may be considered to have a PE and be liable to tax in the source country on the pro ts attributable to it.

3.3 Determining the resident status of the taxpayer

e question of where a taxpayer is resident for treaty purposes is important in applying treaty provisions. Because the meaning of "residence" is governed primarily by domestic law, a taxpayer may be considered a resident in both treaty countries pursuant to their respective domestic laws. In such a case, it is important to apply the treaty tiebreaker rules to determine the taxpayer's residence for treaty purposes.

e issue of dual residence of individuals o en arises where the individual maintains a permanent home and personal and social ties in one country and spends a signi cant amount of time in another country. Under the domestic laws of the visiting (source) country, he is considered a resident on the basis of the length of stay in that country (typically 183 days). Under the domestic laws of the home (residence) country, he is considered a resident on the basis of the permanent home and/or personal and social ties. e issue of dual residence of corporations arises where a corporation is incorporated under the laws of one country, but has its place of central/e ective management in another country.

Wf[VŽTdVS] Vd dg^Ve [` 3df[UV&aXTafZ fZWG` [fW @Sf[a` e and OECD Model Conventions resolve the problem of dual residence of individuals by reference to the location of a permanent home, centre of vital interests (personal and economic) or habitual abode. If these rules fail to break the tie, the competent tax authorities are required to resolve the problem by reaching a mutual agreement according to the procedure established in Article 25. e place of e ective management is the tiebreaker for corporations.

Having access to relevant information is obviously critical to the tax authorities. In general, the taxpayer is the primary source of information and is motivated to provide enough information to break the tie.

3.4 Determining which treaty provision(s) might apply

Once it is determined that a taxpayer is a non-resident carrying on business activities in the source country, the next step is to determine which of the treaty provisions might apply to the taxation of profits arising from such activities. As explained below, business profits may

4.4 Electronic commerce and business activities carried out in the absence of a PE/fixed base

e existing treaty framework for taxing business pro ts relies on the existence of a PE or xed base, as well as the physical presence

with royalties in technology transfer agreements. Since royalties are subject to withholding tax, there is little additional compliance burden on the withholding agent in respect of withholding from technical fees. is is particularly true in the case of business-to-business transactions. Business-to-consumer transactions are more problematic as it is unrealistic to expect consumers to withhold tax from each small amount of payment to non-resident vendors or service providers.

In order to enable the tax authority of the source country to apply Article 12, domestic tax laws need to clearly permit an expansive de nition of royalty and that Article must follow the United Nations Model Convention.

4.5 Non-discrimination

3UUadM[` Y fa 3df[UW$&(%) aXTafZ fZWG` [fW @Sf[a` e S` V A756 Model Conventions, the source country is prohibited from discriminating against PEs of non-resident enterprises. at Article states that the taxation of a PE shall not be less favorably levied in the source country than the taxation levied on enterprises of that State carrying on the same activities. Similar businesses conducted by local residents and non-residents should, therefore, be treated similarly. is is likely one of the reasons why Article 7 prescribes only general principles for the determination of the amount of pro t taxable in the source country. e general rules of accounting and source rules under domestic law generally apply to attributing pro ts to a PE. Similarly, the general rules of tax reporting and payments are presumably the same or similar for domestic enterprises and non-resident taxpayers.

Speci c rules or administrative practices that seek to determine the pro ts attributable to a PE, even if they are di erent from those applicable to branches of domestic companies, are generally not disUd[_ [` Sfadki [fZ[` fZW_ VS` [` YaX3df[UW$&(%) aXfZWG` [fW@Sf[a` e Model Convention. e key test is whether the di erential treatment results in more burdensome taxation for the PE.

5. Permanent establishment

5.1 General threshold and the "effectively connected" rule

Article 7 (1) of both the United Nations and OECD Model Conventions provides that the business pro ts of an enterprise resident in one country cannot be taxed in the other country unless the business is carried on through a PE in that other country (or source country). e existence of a PE is thus a threshold for taxation by the source country. Furthermore, once a non-resident taxpayer has a PE in the source country, not only business pro ts attributable to the PE are taxable in the source country, but so are dividends, interest and royalties if the holding of the shares, debts or property is e ec9(i)-17(s13(n t)21(d f70M)15c)-1t a

5.2 Fixed place of business without specific time requirement

Article 5 (1) of both the United Nations and OECD Model Conventions de nes the term permanent establishment to mean “a xed place of business through which the business of an enterprise is wholly or partly

In determining how long the site, project or activity has existed, no account is taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. In other words, a non-resident taxpayer may spend ve months on each unconnected building site without having a PE.[25] On the other hand, the very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously (for example, building roads or canals) as the project progresses. In this case, the activities performed at each spot are treated as part of a single project and the project is regarded as ldmits ldk6(4l o-27(t o)12(f s527(h)9))-(4e r)

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Owing to the lack of information, it is not easy for the source country to assess a non-resident taxpayer on income that is e ectively connected with a local PE. For example, a MNE resident in Country R that carries on the business of equipment leasing in Country S through a PE in Country S also rents equipment to customers in Country X. If the key employee who works at the PE in Country S plays a key role in negotiating contracts with the customers in Country X, the rental income may be e ectively connected to the PE. However, the customers in Country X have no legal obligation to provide information to the tax authority in Country S. e MNE may decide that the rental payments are not attributable to the PE in Country S and not report it in its tax return. Unless Country S obtains information from the competent tax authority in Country R, there may not be any information on the rental income arising in Country X.

6.3 Transfer pricing issues

e pro ts of the PE are to be determined as if it were a distinct and separate enterprise dealing at arm's length with the non-resident enterprise and other parts of the enterprise. If the enterprise has multiple PEs, the income attributable to each PE must be determined separately. If domestic enterprises are not required to compute the income of each branch separately, a potential tax discrimination issue arises g` WdI3 df[UW$&ž

It is beyond the scope of this chapter to discuss the transfer pricing rules. It su ces to note that there are additional challenges in applying the transfer pricing rules to the PE. For example, the "transactions" between the PE and the enterprise are based on internal agreements, not legally binding contracts. Some enterprises may not keep separate or accurate accounts for each PE. If available accounts do not represent the "real" facts, then "new accounts will have to be

6.4 Deductibility of expenses

e deductibility of expenses is generally governed by domestic law. Expenses incurred for the purpose of earning business income are generally deductible. e amount of deduction may be limited to the reasonable amount.[33]

Only actual expenses incurred for the purposes of the business of the PE are deductible. Payments of royalties, fees for services and interest (other than a banking enterprise) between the PE and the non-resident enterprise are not recognized under Article 7 (3) of the United Nations Model Convention. e ban does not apply to interest, royalties and fees actually incurred and paid to third parties. In the case of internal debts (other than in the case of banks), because money is fungible, it may be di cult to determine the portion of interest payable on internal loans and the portion on loans from third parties. e Commentary on Article 7 of the United Nations Model Convention suggests a practical solution: the determination "would take into account a capital structure appropriate to both the organization and the functions performed taking into account the need to recognize that a distinct, separate and independent enterprise should be expected to have adequate funding".[34]

To take advantage of the rules in Article 7 (3), the source country's domestic tax laws may need to provide similar rules. An VjS_ bVUS` TWXag` V[` 3df[UW&+ aXfZW5Z[` WeW7` fWbd[eW;` Ua_ W Tax Regulations, which states: "In computing income, no deduction

6.5 Source rules

In applying Article 7, a question of geographical source may arise. Does the phrase “pro ts attributable to a PE” mean pro ts resulting from transactions and activities in the PE country or pro ts from transactions and activities connected with the PE, irrespective of whether they are located in the PE country or not? e latter meaning is considered more appropriate.[36] In attributing pro ts to a PE, it is the nexus of a revenue or expense with the business activity of the PE that is important, not necessarily the geographical source of the revenue or expense in the source country. e key is whether the revenue or expense is related to the activities caerurteoiA(y o)12(r p)15(r)8(o)5( )8(t)-11(s F)2

Apportioning of the non-resident enterprise's pro ts to the PE

of the "revenue rule" in international law.[38] is rule is overruled by Article 27 of both the United Nations and OECD Model Conventions, which provides for mutual assistance in tax collection. It is unclear how many developing countries actually include this provision in their tax treaties and if this provision has been used in practice.**Fc**

Chapter VI

Taxation of non-resident service providers

Ariane Pickering*

1. Introduction

Tax treaties provide for a range of di erent tax treatments of income derived by non-resident service providers, depending on the category of services giving rise to the income.

Since the tax treatment permitted under the treaty can range from exemption from source taxation to exclusive source taxation, from limited to unlimited rates of source taxation, and from gross to net taxation, taxation of non-resident service providers can present a number of challenges to tax administrations. In addition to that, there is a wide range of thresholds provided under treaties for source taxation of services income, and, thus, the rules can become extremely complex to administer, particularly for tax administrations in developing counts lm2(a)-21s ong c (4)-20 sermn i
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A few countries consider that Article 12 and/or Article 21, dealing, respectively, with royalties and income not otherwise dealt with under the treaty, are relevant to taxation of income from the provision of services.

Di erent tax treatment is provided for each of these categories of income.

1.1 Article 5 and Article 7 — Business profits

e general provision that applies to income from services under most tax treaties is Article 7, Business pro ts. is Article applies unless the income is dealt with under another article in the treaty.[3]

In accordance with Article 7, pro ts of an enterprise of one of the treaty partner countries from the provision of services will be taxable only in that country unless the pro ts are attributable to a permanent establishment situated in the other treaty partner country. e term “permanent establishment” (PE) is de ned for treaty purposes in Article 5, Permanent establishment and, in the case of treaties that follow the United Nations Model Convention, generally refers to:

¾ A xed place of business through which the business of the enterprise is carried on[4] (xed place of business PE)

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1.2 Article 8 — International transport

Article 8 of the United Nations Model Convention offers two alternative tax treatments for profits from international transport activities. Alternative A adopts the same approach as the OECD Model Convention in providing that profits from the operation of ships or aircraft in international traffic are taxable only in the country in which the enterprise has its place of effective management. Alternative B provides the same treatment for profits from aircraft operations in international traffic, but provides for limited source taxing rights over

- ¾Attributable to a xed base of the service provider in the source State; or
- ¾ Derived from activities performed in the source State if the service provider is present in that State for at least 183 days in a twelve-month period.

e application of this Article raises a number of issues for tax administrations, including:

- ¾ Characterization of income from “professional services or other activities of an independent character”
- ¾ Determination of whether the service provider has a xed base in the source country or has been present, or is intending to be present, in the country for at least 183 days
- ¾ Determination of income attributable to a xed base, or derived from activities performed in the country
- ¾ Collection of tax, particularly where it is not known whether the service provider is likely to be present in the country for the requisite number of days.

Under a few treaties, source taxation is also permitted where the income exceeds an agreed monetary threshold.

1.4 Article 15 — Dependent personal services

e general rule under Article 15 with respect to taxation of employment income (income from dependent personal services) derived by residents of a treaty partner country is that the remuneration may be taxed in the other country only if the employment is exercised in that country.

Notwithstanding this general rule, an exemption from source taxation applies if the following three conditions are met:

- ¾ e employee is present in the source country for 183 days or less in any twelve-month period commencing or ending in the scal year concerned
- ¾ e remuneration is paid by, or on behalf of, a non-resident employer, and

¾ e remuneration is not borne by a permanent establishment or a xed base of the non-resident employer, which is situated in the source country.

A special rule applies under Article 15 for remuneration from employment exercised aboard ship or aircra in international tra c, or a boat engaged in inland waterways transport. Such remuneration may be taxed in the country in which the place of e ective management of the transport enterprise is situated (or in the country of residence of the enterprise, where that formulation is used in the treaty).

Administrative issues raised by the application of this article include:

¾ Identi cation of employment services exercised in the country

¾ Determination of who is the 'employer' and whether the employer is a resident

¾ Determination of the income derived from employment exercised in the country

¾ Imposition and collection of tax.

1.5 Article 16 — Directors and top-level managers

Article 16 of the United Nations Model Convention allocates taxing rights over fees paid by resident companies to directors or salaries, wages and other remuneration paid to top-level managers in respect of

activities are exercised. e source country may also tax the income from their activities if it accrues to another person, such as a team, management company or a star-company.[10]

Since the treaty does not limit the source tax that may be imposed, the issues that tax administrations are most likely to encounter will concern claims by taxpayers that their income is not covered by the Article. e main administrative issues faced by tax authorities will be:

¾ Determination of the character of the income
¾ Identi cation of entertainment activities exercised in the jurisdiction
¾ Imposition and collection of tax.

1.7 Article 19 — Government service

Article 19, Government service, is unique in that it provides for exclusive taxation in the paying State for salaries, wages and other similar remuneration paid in respect of services rendered by an individual to that State. is accords with longstanding rules of international courtesy.

e country of which the individual is a resident may only tax the remuneration if the activities are exercised in that country and the person is either a national of that country or did not become a resident solely for the purpose of rendering the services. In these cir-

1.8 Article 20 — Students

In accordance with Article 20, payments received from abroad by visiting foreign students, business trainees or apprentices for their maintenance, education or training are exempt from tax in the country visited. For purposes of application of this Article, in countries that would otherwise tax such payments, it is necessary to determine:

¾ Whether the recipient is a student, business trainee or apprentice

¾ Whether the recipient is visiting the country solely for the purpose of his education or training

¾ Whether the payments are for the purpose of maintenance, education or training of that person, and

¾ Whether the source of the payments was abroad.

1.9 Other treaty provisions

Many tax treaties, particularly treaties entered into by developing countries, include additional provisions relating to fees for technical services and/or for remuneration of teachers. While these provisions are not currently found in the United Nations Mo-3(s82 Tdu532(sextFEFF02)01(c)

Where a special provision dealing with fees for technical services or technical assistance is included in a tax treaty, it commonly treats the fees as, or in the same way as, royalties which, under the United Nations Model Convention, may be taxed at source at a limited rate agreed by the treaty partners. e scope of the provision and rate limits vary from treaty to treaty. However, the provisions are reasonably consistent in providing:

¾ at the fees are deemed to arise in the country of which the payer is a resident, or if borne by a permanent establishment or xed base, in the country in which the permanent establishment or xed base is situated

¾ e fees may be taxed in that country on a gross basis, albeit the rate of tax is limited where the fees are bene cially owned by a resident of the treaty partner country

¾ Business pro ts treatment will apply if the fees are attributable to activities carried on through a permanent establishment or a xed base of the service provider situated in the source country.

Countries that seek to include these provisions will o en have speci c domestic law rules for the taxation of fees for technical services or assistance provided by non-residents. Many developing countries apply withholding tax to payments for such services. For these countries, the main issues that arise in administering the treaty provisions relate to the determination of the services to which the treaty provisions apply (if their scope is di erent from their domestic law provision) and to the identi cation of the bene cial owner of the fees for purposes of determining whether any reduction in source taxation is applicable.[13] Other issues arise for tax administrations of countries that do not apply withholding tax to such payments. ese include identi cation of relevant payments, and application of tax rate limitations based on the gross amount of the payment.

Under the United Nations Model Convention, remuneration of visiting teachers is dealt with under di erent articles, depending on

[13]Issues relating to bene cial ownership are discussed in chapter I, An overview of the issues involved in the application of double tax treaties, by Brian J. Arnold, chapter II, Persons qualifying for treaty bene ts, by Joanna Wheeler, and chapter VII, Taxation of investment income and capital gains, by Jan J.P. de Goede.

the capacity in which the teaching services are performed, that is to say,
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the treaty. On this view, since Article 21 of the United Nations Model Convention permits taxation by a country of income arising from sources in its territory, tax could be imposed on services income where it is considered to have a source in that country under domestic law.

2. Administrative issues

It is obvious from the discussion above that treaties do not provide a consistent approach to tax treatment of income from services. In determining the correct tax treatment applicable under a treaty provision, tax administrations may need to consider one or more of a number of di erent factors. ese include:

¾ Whether the income is derived by a resident of a treaty partner country who is entitled to treaty bene ts

¾ e character of the income, that is to say the type of services provided, and whether provided by an individual or a legal person

¾ Whether service activities are sourced in the country, for example, exercised in that country or paid by a resident

¾ Whether any applicable threshold for source taxation has been met

¾ e amount of income that may be taxed in the source country

¾ e method of imposing or collecting tax.

2.1 Residence of service provider

Treaties apply to persons who are residents of one or both of the treaty partner countries.[15] For tax authorities, therefore, the rst step in deciding whether treaty bene ts are available in respect of income from services derived from sources in one country is to determine whether the service provider is a resident of the other country for treaty purposes. e issues relating to determination of residence for treaty purposes are dealt with in another chapter.[16]

[15] Article 1 of both the United Nations and OECD Model Conventions.

[16] See chapter II, Persons qualifying for treaty bene ts, by Joanna Wheeler.

For certain categories of services income, a service provider who is a resident of a treaty partner country must fulfil additional criteria for entitlement to treaty benefits in respect of that income.

For purposes of Article 7, Business profits, the service provider must be carrying on an enterprise. The term “enterprise” is not defined in itself in the United Nations Model Convention.[17] It is clear, however, that source taxation is only permitted if the non-resident service provider is carrying on business in that country through a permanent establishment. The term “business” is not defined in the United Nations Model Convention and is defined in the OECD Model Convention only to include professional and other independent services. Tax authorities should determine whether or not the service provider is carrying on an “enterprise” or a “business” by reference to domestic law.

Under Article 8, Shipping, inland waterways transport and air transport, treaty benefits (i.e. exemption from source taxation) will only be available if the place of effective management of the transport enterprise is outside the source country. Determination of the “place of effective management” can be a complex matter, involving the consideration of factors such as where the enterprise is actually managed and controlled, where its board of directors meets, where the highest level of decision-making takes place.

Many countries prefer to assign exclusive taxing rights under the treaty to the country of which the shipping or airline enterprise is a resident, rather than the country where its place of effective management is located.[18] This may be a policy preference, or may reflect

[17] See paragraph 6 of the Commentary on Article 3 of the United Nations Model Convention. Article 3 (1) (c) of the OECD Model Convention provides

concerns about administrative difficulties in determining the place of effective management, especially in countries where this concept does not have a domestic law equivalent. Tax administrations will generally have few difficulties in obtaining the information necessary to verify that an enterprise is a resident of one or other country. Similarly, international transport enterprises that are residents of a State would have little difficulty in obtaining a certificate of residence to that effect in their home country when claiming treaty benefits.

Exemption under Article 20, Students, applies to a student or business trainee or apprentice who "is or was immediately before visiting a country" a resident of the treaty partner State. It follows that exemption may apply, even though the visiting student or trainee has ceased to be a resident of the other country during his visit (for example, has become a resident of the visited country). However, the student or trainee must be visiting the country "solely for the purpose of his education or training". Tax authorities should apply this condition in a reasonable manner. For example, exemption should not be denied merely because a student or trainee visited friends or relatives, or took a short vacation, during his visit.

2.2 Characterization of income

One of the most difficult administrative issues faced by tax authorities is the characterization of services income for purposes of determining which article of the treaty applies. Article 7, Business profits, is the provision that generally applies to income from services. Income from the provision of services, other than services provided as an employee, by an enterprise to another person, would generally constitute profits of an enterprise for purposes of Article 7. However, priority is given to other articles to the extent that the income is dealt with under those other articles in the treaty,[20] subject to the throwback rules in some articles.[21] Accordingly, different types of services income must be distinguished for purposes of determining whether another more specific article of the treaty applies.

The application of the more specific provisions generally depends on the nature of the services provided. Under some articles, the classification of the service provider, for example, as a director or as a teacher, may also be relevant. Some of the more common characterization issues are discussed below.

[20] Article 7(6) of the United Nations Model Convention and Article 7(4) of the OECD Model Convention.

[21] See Articles 10(4), 11(4), 12(4) and 21(2) of the United Nations Model Convention and Articles 10(4), 11(4), 12(3) and 21(2) of the OECD Model Convention.

2.2.1 Nature of the services

Article 8 applies to "profits from the operation of ships or aircraft in international traffic". A challenge for tax authorities is to determine which activities would fall within the scope of the provision. In addition to the carriage by ship or aircraft in international traffic of passengers or cargo, enterprises may carry on a range of related activities, such as

assistance, so as to come within the scope of the provision. Although the terms are not usually defined, "technical services" often include, explicitly or by interpretation, any services of a technical, managerial or consultancy nature. The term "technical assistance" is often used in the context of services connected with the development and/or transfer of technology. However, the precise meaning of these terms is not clear and understanding of the scope of each term differs from country to country. For this reason, it is important that negotiators try to clarify their meaning during negotiations. If different understandings

It should be noted that, in treaties that include provisions for source taxation of technical services, there is potential for overlap between services covered by such provisions and those covered by Article 14. This may need to be resolved through the mutual agreement procedure if the treaty does not provide a priority rule.

The application of Article 15, Dependent personal services, requires that the income be derived from employment services, that is to say, remuneration for services rendered to another person in the course of employment. It is important to distinguish between employment services (to which Article 15 applies) and services provided by an enterprise to another (to which Article 7 or Article 14 applies). It is also important to correctly identify the person who is the "employer" for purposes of this Article (which may be different from the person who is regarded as employer under domestic tax or labour law). Difficulties can especially arise where the services, while performed under a formal contract of employment between the individual and a non-resident enterprise, are rendered to a person who is a resident. Guidance on these difficult issues can be found in the Commentaries.[29]

Article 19, Government service, applies to services provided by State employees in the course of their employment, and to pensions from such employment. It does not apply to independent personal services provided to a State (which would fall within the scope of Article 14 of the United Nations Model Convention).[30] Nor do the provisions apply to services rendered in connection with a business carried on by a government. The usual rules provided with respect to income from dependent or independent personal services, or entertainment activities, apply to remuneration from services rendered in connection with a government business.[31]

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[29]Paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention, and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention.

[30]See paragraph 2.1 of the Commentary on Article 19 of the OECD Model Convention, and paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 2.1 of Commentary on Article 19 of the OECD Model Convention.

[31]Article 19 (3) of the United Nations Model Convention.

2.2.2 Qualification of service provider

A number of articles characterise income according to the quali ca

or administrative or support personnel.[34] e Commentaries also o er guidance on which activities of such persons would give rise to income that falls within the scope of the Article.[35] e Article applies to income of all entertainers, whether they are private or government employees, or providing independent services.

For the purposes of Article 20, whether a person will qualify as a "st cs27(t)-1

this is not always the case. Source taxing rights may also be allocated to a country under some treaty provisions where the payer is a resident of that country (for example, in the case of directors' fees, or fees for technical services). Services income that is attributable to a permanent establishment or fixed base situated in a country may also be taxed in that country. In applying a treaty provision with respect to income from services, tax authorities should, therefore, be aware of the basis on which a source taxing right is allocated and determine whether the relevant nexus exists.

It should be noted that, whatever the treaty rule may be for allocating taxing rights, countries may only exercise that right to the extent that their domestic law permits. The allocation of a taxing right under the treaty does not authorize a country to tax income that would otherwise not be subject to tax under domestic law. Accordingly, in applying source taxing rights allocated under the treaty, tax authorities should also take into account whether the income would be regarded as having a source in their country under domestic law.

2.3.1 Place of performance

physically performed in the source State.[37] A few countries, however, do not agree with this interpretation. India, for example, takes the view that "physical presence of an individual is not essential".[38] Under

a taxpayer identi cation number, or business identi cation number. is may assist tax authorities in tracking this income. Similarly, information provided to relevant authorities under any business registration requirements may, if available to tax administrations, help the administration to identify non-residents carrying on business within a country.

country, then Article 7, and not Article 8, will apply with respect to the income. The foreign enterprise should be able to produce shipping records of each voyage in respect of which exemption from tax is claimed under Article 8. However, the compliance and administrative burden involved in identifying which voyages are in international traffic, and the income derived in the source country from such voyages, is likely to be significant.

Some countries may find it easier to determine whether the journey of the passenger or cargo is confined to places within their territory, irrespective of whether the voyage is made on a ship or aircraft that is operated solely between places in that territory or is used for a voyage in international traffic. If information is more readily available concerning the journey of the passenger or cargo, rather than the journey of the ship or aircraft, these countries may prefer to use in their treaties the alternative formulation of the definition of “international traffic” set out in paragraph 6.2 of the OECD Commentary on Article 3.

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the income is deemed to arise in the country of which the payer is a resident, or if the fees are borne by a permanent establishment or fixed base, in the country where the permanent establishment or fixed base is situated. Such provisions may give rise to administrative complexities, particularly for countries that do not tax fees for technical services by withholding under their domestic law. In these cases, the source of the income for treaty purposes is likely to differ from the source as determined under domestic law. For example, under domestic law, fees for such services may be treated as having a source in a country, and be taxable therein, only if the services are performed in that country. In these countries, information as to the residence of the payer of the fees may not be readily available. It may, therefore, be difficult to determine whether source taxing rights are governed by Article 12 or a Fees for technical services provision (in cases where the fees are paid by a resident or borne by a permanent establishment or fixed base) or by Article 7 (in other cases where the technical services are performed in the country).

The residence of the payer is also relevant to determining whether an exemption from source taxation applies in respect of employment income covered by Article 15. One of the three conditions that must be met in order for exemption to apply under Article 15 (2), is that the employer must not be a resident of the country in which the employment is exercised. Some treaties go further and require that the employer be a resident of the same country as the employee in order for the exemption to be granted.

An employee claiming exemption under this provision may not be in a position to provide the necessary evidence as to the residential status of his or her employer. However, the tax administration should have information as to whether the employer is a resident of the source country (and thus, by default, whether it is not a resident). For treaties that only exempt the employment income if the employer is a resident of the same country as the employee, information as to where the employer is a resident may not be readily available to either the employee or the tax administration of the country in which the services are performed. In these circumstances it may be necessary to seek confirmation of the employer's residential status in the other country through the exchange of information process.

Particular di culties in the administration of Article 15 can arise in cases where an employee is in a formal contractual employment relationship with a non-resident enterprise but whose services are provided for the bene t of a resident enterprise. It is important therefore to correctly identify who is the “employer” for purposes of applying the exemption under Article 15 (2).[44]

Also, to be exempt under Article 15 (2), the remuneration must not be borne by a permanent establishment situated in that State. While the accounts of any permanent establishment of the employer would generally re ect whether or not this is the case, again this information may not be available to an employee who is seeking treaty bene ts under this Article. It should, however, be accessible by the tax authorities.

For purposes of Article 20, payments received by students, trainees and apprentices will only be exempt if the payments “arise from sources outside” the visited country. Payments made from abroad will normally be from sources outside the country. However, the Commentary makes it clear the payments made by or on behalf of a resident of the visited country, or borne by a permanent establishment situated in that country, are not considered to arise from sources outside that country.[45]

2.4 Thresholds

Some treaty provisions allow source taxation of certain types of services income without any minimum threshold conditions, for example, Article 16, Article 17 and Article 19. Other provisions dealing with income from services provide a variety of threshold conditions for source taxation. ese include:

&&See paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention, and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1-8.28 of the Commentary on Article 15 of the OECD Model Convention.

&' BSdSYdSbZ &aXfZW5a_ _ WfSdk a` 3df[UW$" aXfZWA756 ? aWW Convention, and paragraph 2 of the Commentary on Article 20 of the United @Sf[a` e ? aWW5a` hWf[a` ł cgaf[` Y bSdSYdSbZ &aXfZW5a_ _ WfSdk a` Article 20 of the OECD Model Convention.

The same considerations would also apply to the determination of a fixed base. Although a few countries consider there is a difference between the concept of permanent establishment and that of fixed base, the two are generally regarded as identical.[47] The Commentary on former Article 14 of the OECD Model Convention notes that “there were no intended differences between the concept of permanent establishment … and fixed base”.

2.4.2 Time threshold — Presence of service provider

The amount of time the service provider spends in a country may be relevant to the determination of taxation in that country. Article 14 (1) (b) allows for source taxation where the service provider’s stay in the (source) State is for “a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period”. The same time threshold is also relevant to the determination of an employee’s entitlement to exemption from source taxation under Article 15 (2) and to the existence of a permanent establishment under paragraph (a) of the OECD’s alternative deemed services PE provision.[48]

Although the provisions refer respectively to the service providers “stay” in the source country in Article 14 (1) (b) and to the employee being “present” in that country in Article 15 (2) (a) and the OECD alternative deemed services PE provision, the concepts are the same. In all of these provisions, the time threshold refers to days in which the person is in the source State. The time threshold in these provisions refers to the physical presence of the person in the country, and not to the number of days during which services are performed or employment is exercised in the source State.[49] The requirement is therefore only to determine the number of days during which

[47] Ariane Pickering, *Enterprise Services*, General Report, in International Fiscal Association, vol. 97a Cahiers de droit fiscal international (Sdu Uitgevers, The Hague, the Netherlands, 2012), at p. 46.

[48] Paragraph 42.23 of the Commentary on Article 5 of the OECD Model Convention.

[49] See Article 5 (3) (b) of the United Nations Model Convention where the time threshold refers to the number of days during which the service activities are performed.

enterprise where those projects have a commercial coherence. Factors that are generally relevant to this determination are also set out in the Commentary.[52]

In applying either provision, it should be noted that the time threshold applies to the number of days during which services are performed by the enterprise. e services may be performed on behalf of

In treaties that include the force of attraction provisions of the United Nations Model Convention, pro ts that are attributable to service activities carried on in that country that are similar to those carried on through the permanent establishment may also be taxed.

Di culties are o en encountered in determining how much pro t is attributable to the permanent establishment. While these are not signi cantly di erent in the case of services PEs from the problems of determining the pro ts attributable to services performed through a xed place of business PE, they are nevertheless issues of concern to tax administrations. Attribution of pro ts to a permanent establishment is a complex issue and is beyond the scope of this chapter. Tax authorities should follow the guidance provided by the Commentary on Article 7 of the United Nations Model Convention or, if Article 7 of the OECD Model Convention (as of 2010) is adopted in a treaty, the guidance provided in the Commentary to that Article and the 2010 Report on the Attribution of Pro ts to Permanent Establishments.[61]

2.6.2 Withholding tax

Developing countries commonly require payers to withhold tax on a wide variety of payments under domestic law. For many such countries, withholding tax represents the only e ective way of collecting tax on payments to non-residents. If, as is o en the case under domestic law, the resident payer (or permanent establishment of a non-resident payer) is personally liable if they fail to withhold the appropriate tax, there is a signi cant incentive for the withholding agent to comply with the withholding tax requirements. e tax may be levied as a nal tax or on an interim basis (that is to say, as an advance collection of tax). Where interim withholding is levied, the tax withheld is creditable against the taxpayer's nal liability as assessed on the basis of net income disclosed in a tax return led by the taxpayer.

Interim or nal withholding tax is o en levied on:

- Employment income (Article 15 or Article 19)
- ;`VVbVVVVf bVVela`S^eVdh[UVe[`Ua_ VV(3df[UVV#&)
- Directors' fees and remuneration of top-level managers (Article 16)
- Payments to artistes and sportspersons (Article 17)
- Payments made by residents and permanent establishments in respect of technical services (Article 12 or Fees for technical services provisions).

Article 15, Dependent personal services, and Article 19, Government service

Under the domestic law of many countries, resident employers (including government employers) are required to withhold tax from remuneration paid to employees, whether those employees are resident or non-resident. In most countries, the withholding is an interim withholding tax. In some countries, however, the tax withheld may represent a nal tax.

Non-resident employers in the country where the employment is exercised may also be obliged to withhold tax on remuneration paid to employees. However, unless the employer is registered in the source country or has a permanent establishment situated therein, it may be di cult for tax administrations to enforce this obligation.

Article 14, Independent personal services

not know how long the service provider will be present in the country and so will not be able to determine the service provider's entitlement to exemption. Furthermore, if withholding agents are liable for underpaid tax (as is commonly the case when the withholding tax represents the nal tax liability of the service provider), the agent is unlikely to refrain from collecting that tax unless a waiver is issued by the tax authorities. In a few countries, the possibility exists for a taxpayer to apply in advance for such a waiver. However, tax authorities would need to be convinced that the service provider is not going to exceed the relevant time or other threshold provided in the treaty.

It is recognized that, rather than providing an upfront exemption, a country may impose tax in accordance with its domestic law and subsequently refund any tax that exceeds the amount permitted under the treaty. Countries that follow this latter approach should ensure that they have in place procedures that will allow the refund to be made without any undue delay.[69]

[69]Ibid.

Chapter VII

Taxation of investment income and capital gains

Jan J.P. de Goede*

1. Introduction

is chapter 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 speci c issues, including hybrid nancing and thin capitalization. Furthermore, the administrative procedures for granting tax treaty bene ts with respect to the aforesaid di erent types of income will be discussed. To this end, this chapter 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 Develo((i)11(d tp)15(l)-24)10(u6(w)(4)10d1(D)-10(e)219(v)3(e)-8(lop)-13(e)-1p)-13
trocreaty benheai(a)o the afor Tc 0.01(r)8(o)-4t)nc

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 chapter, the focus will be on the main aspects of the definitions as generally used in income and corporate tax (or specific related 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 build-

distributions (such as bene ts granted by a company to its sharehold-

of such rights as royalties. Moreover, the borderline between use and sale is sometimes drawn di erently. Di erent approaches also exist as to whether or not payments for the use of lms and tapes, or for the leasing of various types of equipment, are included in the de nition of royalties. e treatment of payments for so ware may also di er to a

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, although 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 country in which the payer is a resident, but under some domestic legislations 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

capital subsequently treat the interest paid by the debtor as a dividend, on which the withholding tax on dividends may be applied.

in capitalization relates to excessive debt nancing 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

very useful in the enforcement of such taxation, as the payer (generally speaking the withholding agent who is responsible for withholding the tax) usually does not want to run the risk of having to pay taxes and fines if no, or insufficient, tax is withheld. Thus, only limited fiscal intelligence efforts may need to be undertaken to discover tax evasion.

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 State to the other State and thus no resident payer to withhold tax.[15]

In levying taxes by assessment, two systems should be distinguished: self-assessment, and assessment by the tax authorities.[16] This distinction can also affect the way in which the provisions of tax treaties apply.

Obviously, when levying tax by assessment, proper enforcement is more difficult, as no third party is obliged to report and withhold the tax and, thus, the tax authorities have to rely on the proper disclosure and reporting of the income by the non-resident taxpayer. As a result, probably more fiscal intelligence is needed to avoid tax fraud. Obviously, such intelligence is much more difficult if the income is

[15] This latter case, for instance, may occur when a non-resident owns a holiday home in the source country, which is rented out to another non-resident, so that the cash flow fully takes place outside the source State.

[16] Under self-assessment, the taxpayer files the tax return in which all deductions and benefits are taken into account, and then pays the tax due. In this system the tax assessment is final, unless the tax authorities upon audit make a re-assessment. Under assessment by the tax authorities, the taxpayer first files a tax return and the tax authorities then make the assessment after having judged the correctness of the return.

received by a non-resident taxpayer from another non-resident, as there is no pay trail, or deduction as costs, by the payer visible in the source State. e source State, as well as the State of residence where the income may not have been reported, thus, need a su cient legal basis and resources to do audits and investigations.[17]

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Besides the allocation provisions, other provisions are included in tax treaties, such as those on non-discrimination, which are mentioned in the introductory chapter of this Handbook[20] and which will not be discussed further in this chapter.[21]

Against the above-mentioned background, the following aspects are of importance when applying a tax treaty:

- How are the taxing rights allocated for each type of income and gains and how are the latter defined?
- Who is allowed to claim the treaty benefits?
- How can it be assured that the treaty is properly applied so that a taxpayer can realize the benefits of either a lower taxation in the source State, or of relief from double taxation in the residence State as foreseen in the tax treaty?

Before addressing these aspects in the following sections, it is useful to comment briefly on those cases where a tax treaty allocates a

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 de ned in tax treaties, will be considered. It is important to understand that such de nitions or classi cations only apply for the purposes of the allocation of taxing rights under tax treaties and have no direct bearing on the classi cation of such income or gains under domestic law, or on the system of levying taxes under domestic law. For

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.[23]

It is mentioned[24] that no provisions are included in Article 6 of both the United Nations and 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 (3) of both the aforesaid Model Conventions also makes clear that 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.[25]

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[23] See supra footnote 6.

[24] Paragraph 7 of the Commentary on Article 6 of the United Nations Model Convention and paragraph 2 of the Commentary on Article 6 of the OECD Model Convention.

[25] 8adfZWeS] WaXUa_ b^VfVVeel dVXdVUW[e_ SVVfa bSdSYdSbZ &aXfZW Commentary on Article 6 of the United Nations Model Convention, where the specific situation of time-sharing is briefly discussed and to paragraph 3 of the Commentary on Article 6 of the OECD Model Convention, which deals with the specific situation of Real Estate Investment Trusts (REITs).

3.3 Dividends

Under Article 10 of both the United Nations and OECD Model Conventions, the taxing right on dividends paid by a company resident in one country[26] 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 bene cial owner[27] is a resident of the other country, whereas the latter country is also allowed to tax the dividends but must provide relief of double taxation. In the OECD Model Convention the tax of the country of source is limited to a maximum of 5 per cent of the gross amount of the dividends for qualifying participations, and to 15 per cent of the gross amount for portfolio participations. In the United Nations Model Convention, the percentages are le open to be established during the bilateral negotiations.

It should be noted that the threshold of participation required to be able to bene t from the lower rate for qualifying participations is lower in the United Nations Model Convention than in the OECD Model Convention (respectively, 10 per cent and 25 per cent of the capital of the company paying the dividends).

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pro ts of the permanent establishment under Article 7. As there is no treaty bene t regarding the taxation of the dividends in the source country, this matter will not be further considered.

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 United Nations and OECD Model Conventions, for the tax levied in the source country.

e de nition of dividends as provided in Article 10 (3) of both the United Nations and 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 pro ts, and ends with an open formula that also includes income from other corporate rights which is treated the same as income from shares by the laws of the country in which the company making the distributions is a resident. us, the de nition is open ended, and it generally covers the distributions of pro ts by limited liability companies and also, in many countries, such distributions by co-operative societies. It can equally cover distributions by non-transparent partnerships subject to the same taxation as the pro ts of companies. [illegible]

the risks of the company must be determined in each individual case in the light of all the circumstances, including the following:

¾ e loan very heavily outweighs any other contribution to the capital and is substantially unmatched by redeemable assets
¾ e creditor will share in any pro ts of the company
¾ Repayment is subordinated to other creditors or to payments of dividends
¾ e level of interest depends on the pro ts
¾ ere are no xed provisions in the loan contract for repayment by a de nite date.

is clari es the treatment of interest as dividends for tax treaty purposes in the case of hybrid nancing and of thin capitalization legislations mentioned in section 2.3.

Due to this broad, open treaty de nition of dividends, domestic de nitions of treaty countries will almost always be covered under the treaty de nition. ere could be, however, very speci c 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 (3) of both the United Nations and OECD Model Conventions seems to be that there should be a distribution of income by the company or other entity covered. at would seem to imply that, for instance, the gain derived from the sale of shares by a shareholder would generally not be covered by Article 10, but by Article 13, even though the source country treated 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.[33]

[33] is might perhaps be di erent where, as part of a set of arti cial transactions, the main purpose of which would be bene ting from a more favorable tax treatment by transforming dividends into a capital gain, such capital gain could be re-classi ed as dividends for domestic law purposes (for example, under a general anti-abuse provision, such as substance over form). en, this re-classi cation might also occur for treaty purposes, if the circumstances were such that the more favorable treatment as capital gain would be contrary to the object and purpose of the relevant treaty provisions.

paid is attributable to a permanent establishment[35] that an enterprise resident in the other country maintains in the source country.[36] In such cases, the source country is allowed to fully tax the interest as part of the profits of the permanent establishment. As there is no treaty benefit to be granted regarding the taxation of the interest in the source country, this matter will not be further discussed.

In all of the cases where the source country is allowed to tax the income, 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 Model Conventions for the tax levied in the source country.

The definition of interest in Article 11 (3) of both the United Nations and OECD Model Conventions is identical. In this case, it is a closed (or exhaustive) treaty definition, which does not refer to domestic law. The core elements of the definition are as follows: income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the profits of the

instruments where there is no underlying debt (such as various types of interest rate swaps) are generally not considered as interest, unless a loan is deemed to exist under an anti-abuse provision, such as substance over form or a similar doctrine.[39] Furthermore, it is clari ed that the de nition applies to Islamic nancial instruments where the economic reality of the contract underlying the instrument is a loan (even if the legal form thereof is not).[40]

In addition, it should also be noted that in both the United Nations and OECD Model Conventions a provision (Article 11 (6)) has been included, which makes clear that in the case of a special relationship between the bene cial owner and the payer or between both of them and some other person, the provisions of this Article only apply to the part of the interest which would have been agreed upon had they dealt with each other on an arm's length basis. For the notion of special relationshipC()2(d)fwere3e-5(e)(4n)9(e).2(t w)pdy

as a dividend under the domestic tax law of the payer, and thus also as a dividend for tax treaty purposes.[43]

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, or no tax at all, to be levied in the

3.5 Royalties

As described below, there are fundamental di erences between the United Nations Model Convention and the OECD Model Convention regarding Article 12, which cause this Article to pose more problems in terms of tax treaty administration than the articles on other types of income mentioned above.

First of all, under Article 12 (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 bene cial owner of the income, are exclusively allocated to the residence country of the recipient. Under Article 12 (1) and (2) of the United Nations 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 le open for tax treaty negotiations, as in the case of Articles on dividends and interest.

Under Article 12 (5) of the United Nations Model Convention,[46] 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 maintained in that country by a resident of the other treaty country. us, as in the case of dividends and interest, the country of source of the royalties is determined by the treaty.

Finally, under Article 12 (3) of the OECD Model Convention S`V 3df[UW#$ (&) aXfZW G`[fW @Sf[a`e? aWW5a`hWf[a`1[47] there is

&(Article 12 (5) of the United Nations Model Convention contains a simi-^Sdg^W[` USeWfZWdWe[VWf aXfZWafZWdUag`fdk [eUahWdWVTk 3df[UW#&aX that Model Convention (not included in the OECD Model Convention) and the royalties received are attributable to a xed base maintained by that person in the source country.

&) 3df[UW#$ (&) aXfZW G`[fW @Sf[a`e? aWW5a`hWf[a` Ua`fS[`eSe[_ [-^Sdg^W[` USeWfZWdWe[VWf aXfZWafZWdUag`fdk [eUahWdWVTk 3df[UW#&aX that Model Convention (not included in the OECD Model Convention) and the royalties received are attributable to a xed base maintained by that person in the source country. It also allows for taxation of the royalties as part of the pro ts of a permanent establishment in case the royalties are attributable to it under Article 7 (1) (c) of that Model Convention.

no limitation of the taxing rights of the source country, if the royalties paid are attributable to a permanent establishment[48] that an enterprise resident in the other treaty country maintains in the source country. In such cases, the source country is allowed to fully tax the royalties as part of the profits of the permanent establishment. As there is no treaty benefit to be granted regarding the taxation of the royalties in the source country, this situation will not be further considered.

In all of the cases where the source country is allowed to tax the income, the country of residence of the recipient of the income may also fully tax such income, but then it must provide relief in accordance with Article 23 of both the United Nations and OECD Model Conventions for the tax levied in the source country.

Although the larger part of the definition of royalties in both the United Nations and OECD Model Conventions is the same, there are some important differences.[49] 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 payments for know-how and basically covering undisclosed knowledge and experience).

Under the United Nations Model Convention, however, the def-

detail in the Commentaries to these Model Conventions. us, there are considerable chances that the interpretation of the term royalties under treaties deviates from its interpretation under domestic laws.[50]

Finally, it should be noted that in both Model Conventions a provision (Article 12 (6) of the United Nations Model Convention S`V3dff[UW#$(&) aXfZWA756 ? aWW5a`hWf[a`) ZSeTWW [`UgVW which makes clear that in the case of a special relationship between the bene cial owner and the payer, or between both of them and some other person, the provisions of the Article only apply to the part of the royalties which would have been agreed upon had they dealt with each other on an arm's length basis.[51]

Although the de nition of royalties is rather broad, there are still considerable chances that the domestic notion and the treaty notion deviate due to the interpretation issues mentioned above. If 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

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[50]For instance, relevant issues may include:

- the borderline between certain types of rights to use and partial sales (for instance the transfer of rights that constitute a distinct and speci c property);
- the borderline between royalties and fees for technical services and also mixed contracts (some treaties include provisions on technical services in the article on royalties or include a separate article on these services);
- the borderline between use of know-how, services and rental income in the context of satellites and other means of communication;
- the borderline between royalties and rights to distribute products and services;
- the speci c aspects of the use and transfer of various types of so ware;
- the classi cation of payments in the context of e-commerce;
- the provision of di erent rates for di erent types of royalties.

be a need to make arrangements to allow the taxpayers to claim the treaty bene ts. ese arrangements may also be needed in view of the veri cation of the requirements for entitlement to the treaty bene ts (for instance, bene cial ownership and, where relevant, the di erent fkbWeaXdakS'f[We)žEgUZ bdaUWgdWeSdWWS'f i [fZ[` eWUf[a` &ž&TWeai ž

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Article 13 (1), (2) and (3) of both the United Nations and OECD Model Conventions deal respectively with cross-border gains on directly held immovable property, assets belonging to a permanent establishment in the other country, and ships and aircra operated in international tra c and boats used in inland waterways transport, including movable property pertaining to the operation by such means of transport. e allocation of the taxing rights follows the same allocation as the income from such activities as provided in Articles 6, 7, and 8, respectively. If tax is levied, that is usually done via assessment, with the consequent enforcement problems of being informed of the transactions and securing that the tax due can be e ectively levied.

assessment on the net amount of the gain. e tax may be di cult to enforce in the source country, in particular if the company or entity is a resident of the other country, or if the seller or buyer is not a resident of the source country, or in the case of sale of shares or participations in companies or other entities that, in turn, own directly or indirectly, through a corporate chain, the company or entity which owns the immovable property. If the buyer is a resident of the source country it may be easier to nd information helpful to secure the enforcement of the taxation on the seller, but, in the case of a non-resident buyer, reporting requirements or withholding obligations imposed in respect of the gains may be di cult to enforce.

Article 13 (5) of the United Nations Model Convention also allocates an unlimited taxing right to the source country in the case of the alienation by a resident of the other treaty country of shares directly held in a company resident in the source country. It only applies if the shareholder held directly or indirectly at least a certain percentage (to be determined in the nego82mont in the62he20d iv erce4(e c)u[(o[(h)9(e)2(t o)h
20(i)11(c(e)2(t o)h)9(i)-15(r)10-4(c)-17(t)-29(l)5(y)5t in the6e.t ma7r

cases where the source country has a taxing right under its domestic law, but the treaty allocates an exclusive taxing right to the country of residence (as, for example, in the case of the sale of shares not covered by the provisions discussed above). In such cases, there may be a need for arrangements to secure treaty bene ts for the taxpayer. ese SdtS` YV_ WfeSdVWVS'f i [fZ [` eWf[a` &ž ž

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with the treaty.[57] It should be mentioned that conflicts of qualification have not been discussed by the United Nations Committee of Experts on International Cooperation in Tax Matters yet and, thus, the Commentaries to the United Nations Model Convention take no position with respect to this interpretative issue.

Finally, it should be mentioned that the interpretation of the OECD only applies to those conflicts which arise from the application of domestic law, and not if they occur because of 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 United Nations and OECD Model Conventions. Therefore, if faced with conflicts of qualification, countries which are not members of the OECD, as is the case for almost all developing countries, should consider whether such interpretation is acceptable to 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 to 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 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

[57]On the other hand, in the reverse situation (that is to say, the source country considers the Article on capital gains applicable, while the country of residence considers the Article on dividends 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.

erefore, the most feasible approach seems to be describing a kind of general common denominator in the practices which are normally followed by countries,[61]

Under all methods and procedures used, the entitlement to treaty bene ts of speci c structures (such as partnerships, trusts, collective investment vehicles, pension funds and charities) may pose problems.[63] If not solved in the treaty or in interpretative mutual agreements, as provided under Article 25 of both the United Nations and 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 herea er, separately for each speci c category of investment income and capital gains.

4.3 Income from immovable property

In many countries, tax on income from immovable property is levied by way of (self-) assessment[64] and tax treaties generally allocate an unlimited taxing right over income from immovable property to the country where the property is located.[65] erefore, generally it is not necessary to make any speci c arrangement for granting treaty bene ts to non-residents in the country where the immovable property is situated.

e main issue seems to be how to nd out that a property is owned by a non-resident and whether or not the non-resident earned any income from exploiting 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 that such information is available to the tax administration, in addition to any speci c scal intelligence measures (such as, searching and reporting

[63]See chapter II, Persons qualifying for treaty bene ts, by Joanna Wheeler.

(& is income may be taxable on a net income basis (which requires the taxpayer to be able to demonstrate which costs were incurred), or on an imputed income basis (for instance, in the case of owner-occupied holiday homes, where there is no cash ow on which a withholding tax could be levied).

[65]See supra section 3.2.

on advertisements in which the immovable property is o ered for rent, which may be di cult 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 the case of non-residents a special entity is o en 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.[66] In such cases, the payer of the rent is required to withhold the tax and pass it on to the designated tax authorities.

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In the case of taxation by assessment by the tax authorities, it seems useful to include a requirement that the taxpayer should explicitly mention in the tax return whether relief for double taxation is claimed. In the case of self-assessment, it would also be desirable to have such information available, as the tax authorities would then be aware that such relief has been claimed and, thus, may decide to check whether the taxpayer is indeed entitled to it or not.

If the income derived from the immovable property in the other country should have been reported but this was not done, it may be di cult for the authorities of the residence country to discover that. Besides limited options of scal intelligence (which may be successful, for instance, if the resident advertises that a house is for rent), automatic international exchange of information with respect to the possession of immovable property may provide a solution.

4.4 Dividends, interest and royalties

Aspects of tax treaty application regarding dividends, interest and royalties will be dealt with together, as most countries impose a withholding tax on the gross amount of these payments made to nonresidents. e withholding agent is responsible for withholding the correct amount of tax. Such a system is, of course, attractive to the tax authorities from the perspective of both technical simplicity and e ective enforcement.

Due to the allocation of taxing rights with respect to these types of income under tax treaties,[68] the country of source is usually only allowed to tax the income up to a certain percentage of its gross amount. If the domestic source tax exceeds the level of tax allowed under the treaty, arrangements need to be made to provide for any reduction or exemption of source country taxation, as may be required.

Although, as mentioned above, there are no generally accepted standard procedures for providing treaty bene ts, in the case of cross-border payments of dividends, interest and royalties, source countries generally apply either a system of refund or a system of reduction of the withholding tax at source to grant the bene ts to a resident of the other treaty country, who is the bene cial owner of the income.

[68]See supra sections 3.3-3.5.

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 bene cial owner can le a request for refund with the designated tax authorities[69] if the amount withheld exceeds the limit imposed by the tax treaty. For example, if 30 per cent 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 per cent tax on the gross amount of the payment, the refund would amount to 20 per cent. In the case of portfolio investments, like securities, such requests are o en made on behalf of the taxpayer by nancial intermediaries, like banks. Of course, such 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 countries where such requests are frequently made, the requests for refund are generally made via a form,[70] which is speci cally designed for each category of income, and through which relevant information needs to be provided. e forms may be either in paper or electronic format.

Generally, the information to be provided includes at least the following elements:

¾ Name, address, tax identi cation number[71] and bank account of the recipient

¾ e amount of income and the date at which it was received, as well as proof of the amount of tax withheld

¾ If the tax treaty provisions distinguish among various types of dividends, interest and royalties to which di erent treaty rates

[69] O en, this is the inspector who is competent for the withholding agent,

apply, a statement indicating which category of income and which percentage of tax is considered applicable

- If it is relevant for the identi cation 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 con rming that the person is a resident of that country (referred to as certi cate of residence[72]).

Furthermore, speci c additional requirements may apply, like a statement by the recipient that he/she is the bene cial owner of the income,[73] or other requirements in the case of speci c anti-avoidance provisions.[74]

Besides the certi cate of residence, the taxpayer may also be required to acquire a statement by the tax authorities of the residence country as to whether certain other requirements have been met. However, as that puts an additional burden on these tax authorities, it is 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 the use of such forms, it may be agreed between the treaty countries that the forms duly certi ed by the competent authorities of the country of residence of the recipient will be sent directly to the competent authorities of the source country.

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[72]It should be noted that issues have been raised about the value of such certi cates. ese relate, for instance, to the question of whether the tax authorities of the country of source should rely on such statements when deciding about granting treaty bene ts, as well as to situations where an entity is considered as transparent in the residence country (and, thus, statements regarding the residence of the participants in such an entity may be provided), but as non-transparent in the source country (where the entity itself will not be considered as a resident liable to tax in the residence country). Such issues of treaty entitlement have been addressed in chapter II, Persons qualifying for treaty bene ts, by Joanna Wheeler.

[73]Such self-certi cation is for instance included in the forms developed in the context of the OECD Treaty Relief and Compliance Enhancement (TRACE) — Implementation Package, which is dealt with infra in section [illegible]

[74]See chapter II, Persons qualifying for treaty bene ts, by Joanna Wheeler.

It is also advisable for the tax authorities of the source country 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) such procedures, which can then also be published in the other country, for the bene t of its taxpayers.

e refund could be based on a formal decision entitling the taxpayer to le an appeal against it.

A refund procedure is attractive to the source country from a budgetary perspective, as the country keeps the tax withheld until the application has been received and veri ed and the refund has been made. However, it is not attractive to foreign investors, as initially they only receive the payments as reduced by the full withholding applicable under the domestic law of the source country. is 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 to 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 nalized and communicated to the withholding agent before the time of the payment of the income.

Generally speaking, this method also works with paper or electronic application forms which have requirements similar to those mentioned above in the case of refund, including the certi cation of the residency of the recipient by the competent authorities of the country of residence. A er ling the applications, and veri cation and approval by the designated tax authorities of the source country,[75] 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. However, if the

deal with the requests in a timely manner, 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 led for each payment; however, to be e cient, it is increasingly agreed between the competent tax authorities — especially in the case of regular payments, such as those on loans, licenses or shareholdings which last several years — that the certi cate 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 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 su ciently demonstrated that they are entitled to such bene ts. Withholding agents may, however, be reluctant to do that, because if it happens that the non-resident taxpayer was not entitled to the treaty bene ts, the withholding agent may be held liable to pay the additional tax due, as well as nes, to the tax authorities.

Finally, in cases where the source State is allocated a right to levy a tax on 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 United Nations and OECD Model Conventions.[76] Generally, such relief will be requested by the taxpayers when ling their tax return or by self-assessment. If the income should have been reported and this was not done, such fraud could only be discovered by scal intelligence or through international exchange of information.

4.4.3 Treaty Relief and Compliance Enhancement (TRACE)

It should be clear from the methods described above that they may be quite burdensome to implement, both for taxpayers and tax authorities, and could create a serious obstacle for taxpayers to receive the treaty bene ts.

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On 11 February 2013, the OECD published a "Treaty Relief and Compliance Enhancement (TRACE) — Implementation Package",

forms for both individuals and entities are included in the TRACE—Implementation Package.

in inland waterway transport is granted to the country in which the place of e ective management of the enterprise is situated. Even if a source country could tax such gains under its domestic law, it should refrain from doing so if the place of e ective management is in the other country. e tax on the pro ts of an enterprise is usually levied by assessment. In the case of self-assessment and assessment by the tax authorities, and assuming that there is no other taxable income in the source country, the taxpayer might not be required to le a nil assess

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.

If 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 bene ts. 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 by the competent tax authority. Depending on the organization of the tax administration, that competent tax authority may be

¾ Legislative aspects

¾ Availability of information

¾ Organization of the tax administration applying the domestic law and tax treaties, and

¾ Collection of the taxes.

Only a selected number of these aspects will be analyzed, with speci c respect to the types of income and gains covered in this chapter. Aspects regarding domestic law and international law will be dealt with separately. In the context of the latter, some attention will also be paid to the Foreign Account Tax Compliance Act (FATCA), which was enacted in the United States of America in 2010,[89] as it may have an impact on nancial institutions and tax authorities in 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 di erent types of income and gains dealt with in this chapter.

e following aspects regarding legislative issues can be considered:

¾ Is the legal basis for applying tax treaties su cient (including both the application of substantive tax provisions and of formal provisions, such as, for instance, in the case of international exchange of information and assistance in the collection of taxes)?

¾ 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 bene ts?

¾ Is the notion of immovable property properly de ned in domestic law and is there clarity regarding immovable rights?

[89] FATCA is aimed at enforcing United States tax liability on United States taxpayers who hold unreported accounts via foreign nancial institutions.

As regards information, the following points may deserve attention (besides the points regarding information already listed above):

- ¾ Is information regarding ownership of immovable property situated in the country available and used?
- ¾ Is information regarding payments of dividends, interest and royalties available and used?
- ¾ Is tax technical information on international tax issues (including texts of tax treaties concluded, case law, literature, etc.) available within the tax administration for persons involved in these matters?
- ¾ Can international assistance regarding information be e ectively used?
- ¾ Is there su cient scal intelligence to gather relevant information regarding the various types of income (for instance, to nd 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:

- ¾ Is there enough international tax expertise in the units dealing with international tax matters?
- ¾ Are there enough resources available to apply tax treaties?
- ¾ Should certain international tax matters be dealt with by local units or by specialized units (such as, for instance, taxation of non-residents by assessment and decisions to allow withholding agents to provide tax treaty bene ts at source)?
- ¾ Are there su cient language skills in the units dealing with international tax matters?
- ¾ Is there a separate scal intelligence unit for gathering and distributing relevant tax information on international tax matters?

As regards the collection of taxes, the following points may deserve attention:

- ¾ Are withholding tax systems adequately applied?
- ¾ Can international situations be properly handled?
- ¾ Can international assistance in collection be provided or requested?

- Can refunds be managed properly and are there incentives to grant them 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 di er- ent types of income and gains dealt with in this chapter:

- Do tax treaties allocate taxing rights to a country which cannot be enforced by that country?
- Do the tax treaties or administrative cooperation 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 their proper application and enforcement of the relevant taxes?

5.4 Foreign Account Tax Compliance Act

Although primarily focused on combating tax evasion by United

determine whether United States taxpayers are the bene cial owners of the income. ey should also withhold and pay over to the IRS 30 per cent of any pass-through payment by the FFI to non-participating FFIs or to recalcitrant account holders. Non-compliant or non-participating FFIs will face a 30 per cent withholding tax on any payments to them of dividends, interest and royalties and other periodic payments from United States sources, and of gross proceeds from the sale or disposition of property that can produce United States source interest or dividends. To address foreign local law impediments to comply with FATCA, simplify practical implementation and reduce costs for foreign FFIs, intergovernmental agreements have been concluded, or are being concluded, by the United States with 50 jurisdictions, based on model Inter-Governmental Agreements (IGAs), under which the FFI's provide certain agreed information to the tax authorities in their own country, which these authorities would then pass on to the IRS via exchange of information.

Chapter VIII

Dispute resolution: the Mutual Agreement Procedure

Hugh J. Ault*

1. Introduction

1.1 Function of the Mutual Agreement Procedure

Article 25 of the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] (United Nations Model Convention) is a very important procedural provision for the application and implementation of the bilateral treaties based on the Model Convention. It provides for the establishment of a "mutual agreement procedure" (MAP) which enables the parties to the treaty to better carry out the substantive provisions contained therein, which allocate taxing rights. The MAP is administered by the "competent authorities", who are generally named in Article 3 (e) of the treaties based on the United Nations Model Convention. It is very important to make clear the persons who will be designated as competent authorities. Typically, they come from the ministry or tax authority (that is to say, the responsible branch of the governments of the contracting States). They are the persons who are normally responsible for administering the treaty and the mutual agreement procedure in Article 25 sets forth the agreed rules and principles for ensuring that the functions of the treaty are properly adhered to. The role of the competent authorities in Article 25 is to "endeavour to resolve" by mutual agreement any difficulties or doubts arising as to the application of the treaty. It applies in connection with all articles of the convention.

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[1]United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

govern intergovernmental communications and allows e cient communication between the two tax authorities. Communications can take various forms, including face-to-face meetings, exchanges of documents or positions papers and other forms of informal contacts. 3df[UWS' (&) XadeWWeUfZSf fZWfi a Ua_ bWfWf SgfZad[f[We _ Sk WefSWb bilateral procedures to deal with the various detailed questions which are necessary to implement the MAP. All information exchanged under the MAP procedures is subject to the con dentiality requirement of Article 26.

1.3 Outcomes of the MAP

In the case of a taxpayer-initiated MAP, the normal result is an agreement between the competent authorities as to how the treaty should be applied in the taxpayer's case with both of them thus applying the same interpretation of the treaty.   e taxpayer typically has the right

(OECD Model Convention),[5] the MAP is in principle available to the taxpayer in addition to his normal legal remedies under domestic law. us, it is important to clarify clearly the exact relation between the two systems of relief which is a matter of domestic law. If a domestic court has already reached a decision in the case at issue, the competent authority may be bound by the decision of the domestic court and may

2. Taxpayer-initiated MAP

2.1 General

By far, most MAP cases involve a complaint by the taxpayer that it is not being taxed in accordance with the substantive rules in the treaty allocating taxing jurisdiction between the two contracting States, thus resulting in unrelieved double taxation which defeats the purpose of the treaty. This can involve a dispute with either the source country as to whether that country has the right to tax under the treaty or with the residence State as to when it is required to give double tax relief.

2.2 Basic requirements for a taxpayer-initiated MAP

To make a request for a MAP, Article 25 of both the United Nations and OECD Model Conventions requires that the taxpayer be a resident of one of the contracting States and establish that an action by one or both of the States results or "will result" in taxation not in accordance with the treaty. The request is made to the State of which the taxpayer is a resident, even if the claim relates to taxation imposed by the other State. It should be noted that the taxpayer has the right to make a MAP request if the actions "will result" in its being inappropriately taxed. It is not necessary that the taxpayer has in fact already been charged to tax. Thus, for example, if a law has been enacted that, when applied to the taxpayer would, in its view, result in inappropriate taxation, the taxpayer would be able to request a MAP provided it had or expected to have income of the type covered by the newly enacted law.

2.2.1 Information requirements

For the MAP to be successful, the taxpayer requesting it must provide the necessary information for the competent authorities to assess the case. Some countries have developed a formal procedure which must be followed by the taxpayer in its MAP requests. While the requirements vary somewhat, the following basic information should be required in order for the MAP request to be processed.[7]

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[7] United Nations Guide to the MAP, paragraph 94.

(a) e name, address and any taxpayer identi cation number of the taxpayer;

(b) e name, address and any taxpayer identi cation number of the related foreign taxpayer(s) involved (for transfer pricing cases);

(c) e foreign tax administration involved and, if relevant, the regional or local tax administration o ce that has made, or is proposing to make, the adjustment(s);

(d) e tax treaty article that the taxpayer asserts is not being correctly applied, and the taxpayer's explanation of how it believes the article should be interpreted and/or applied;

(e) e taxation years or periods involved;

(f) A summary of the facts, including the structure, terms and timing of all relevant transactions and the relationships between related parties (the taxpayer should advise the competent authority of how the facts may have changed during or a er the relevant taxable period, and of any additional facts that come to light a er the submission of the MAP request);

(g) An analysis of the issues for which competent authority assistance is requested and the relevant legal rules, guidelines or other authorities (including any authorities that may be contrary to the conclusions of the taxpayer's analysis). e analysis should address all speci c issues raised by either tax administration as well as the amounts related to the adjustment(s) (in both currencies and supported by calculations, if applicable);

(h) For transfer pricing cases, any documentation required to be prepared under the domestic legislation of the taxpayer's State of residence (where the volume of a taxpayer's transfer pricing documentation is large, a competent authority may determine that a description or summary of the relevant documentation is acceptable);

(i) A copy of any other relevant MAP request and the associated documents led, or to be led, with the competent authority of the other contracting State, including copies of correspondence from the other tax administration, copies

during the period of the MAP.[8] Where the competent authority has found the taxpayer's MAP request to be justified, it would not be consistent with the basic purposes of a MAP resolution to further require the advance payment of the tax obligation in dispute. If the taxpayer ultimately prevails in its claim and the tax paid in advance is refunded, the taxpayer will have suffered the loss of the time value of money loss in connection with the payment. While these issues can in some cases be resolved by the application of interest payments and charges, it is simpler and more consistent with the underlying goals of the MAP not to require payment. This may in some cases require changes in the country's domestic law to ensure that collection during the MAP can be suspended.

2.2.3 Time limits for taxpayer-initiated MAP

taxation itself, for example, the payment of an amount which is subject to a withholding tax or the actual issuance of a notice of assessment or o cial demand for collection. In cases of self-assessment, in general, the taxpayer's ling of a tax return does not in itself constitute a noti- cation. ere must be some action on the part of the tax authorities, such as the denial of a claim for refund or the issuance of a notice of liability which makes the taxpayer aware that taxation not in accord-

to a nal court decision that the tax authority is required to follow, a
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2.4 Unilateral resolution

When a request for a MAP has been accepted, Article 25 of both the United Nations and OECD Model Conventions provides that in the rst instance, the residence country should attempt to resolve the case unilaterally, for example, by granting a tax credit or giving an exemption which would be justi ed in the particular circumstances of the case. If unilateral resolution is not successful, the competent authority of the residence State then contacts the competent authority of the partner State to begin bilateral discussions.

2.5 Structure of bilateral MAP negotiations

If the requested residence State cannot solve the inappropriate taxation unilaterally, it then typically opens discussion with the other State regarding a solution to the inappropriate taxation asserted by the taxpayer in its request. While these stepher iap08l4eti;l4etT/(e)-7(s)-0]TJu0 Tc 07v

(f) A complete description of the issue(s) presented, the relevant tax administration actions and adjustments, and the relevant domestic laws and treaty articles;

(g) To the extent relevant and appropriate, calculations and supporting data (which may include nancial and economic data and reports relied upon by the tax administration, as well as relevant taxpayer documents and records).

A er the receipt of the initial position paper from the competent authority of the residence State, the other State may nd it useful to provide a rebuttal or response statement. is paper would be focused on responding to the points raised in the initial position paper and would typically contain:[15]

(a) An indication whether a view, resolution or proposed relief presented in the initial position paper can be accepted;

(b) An indication of the areas or issues where the competent authorities are in agreement or disagreement;

(c) Requests for any required additional information or clari cation;

(d) Other or additional information considered relevant to the case but not presented in the initial position paper; and

(e) Alternative reasoned proposals for resolution.

A er this initial exchange of views, the competent authorities will continue their discussions, which will typically end in a face-to-face meeting in which a nal resolution of the case may be achieved. If no successful agreement is reached, the issues preventing the resolution of the case may be submitted to arbitration, as discussed in eVUf[a` &ž$ TVai ł [XS'fWd' Sf[hW4 aX3 df[UW$' aXfZWG` [fW @Sf[a` e Model Convention is followed.

2.5.1 Participation of the taxpayer in the MAP process

While the taxpayer has a right under Article 25 of both the United Nations and OECD Model Conventions to submit a request for a MAP, the process, once undertaken, is a government-to-government relationship. Nonetheless, successful MAP requires close cooperation

[15] United Nations Guide to the MAP, paragraph 173.

between the taxpayer and the competent authorities. The taxpayer provides the necessary information to the competent authority in its State of residence which, in turn, communicates that information to the other State. It may be necessary to request further information or clarifications from the taxpayer. Depending on the situation, the competent authorities may permit the taxpayer to submit briefs or make presentations to either one or both of them. These presentations may also contain taxpayer proposals for the resolution of the case. However, direct taxpayer's participation in the competent authority negotiations would not be appropriate, given the differing interests of the parties, though timely indications to the taxpayer of the status of the negotiations would be useful in moving the case forward.[16]

2.6 Implementation of the MAP result

2.6.1 General

Assuming that the MAP negotiations have successfully reached an

condition the agreement on its acceptance by the taxpayer within a certain time period.

related entities, the resulting double taxation is "economic", that is to say, the same item of economic income is being taxed to two different taxpayers. Thus, when a transfer pricing adjustment is made to increase the income of one of the related parties, that same economic income will have also been taxed by the other State in the hands of its resident taxpayer. The application of Article 25 to this situation involves some special considerations.

2.7.1 "Corresponding" or "correlative" adjustments

The United Nations Model Convention and many existing treaties contain a special provision in Article 9 (2) which deals with the situation of potential economic double taxation. That paragraph provides that where one State makes an adjustment of the profits of its taxpayer (the "primary" adjustment) to reflect what in its judgment the appropriate transfer price should be, the other State "shall" make an appropriate adjustment (the "corresponding" or "correlative" adjustment) to its taxation of the related party in its jurisdiction. Thus, potential double taxation of the same economic income will be eliminated.

On its face, the primary adjustment by the first moving State would seem to require the other State to follow the determination of that State in establishing the appropriate transfer price. However, paragraph 6 of the Commentary on Article 9 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 9 of the OECD Model Convention, indicates that the second State is only required to agree to the adjustment if it considers the adjustment justified "both in principle and as regards the amount". If this is not the case, that is to say, if the second State does not agree with the primary adjustment made by the first State, then paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 10 of the Commentary on Article 25 of the OECD Model Convention, makes clear that in such a case the MAP can be used to determine if the adjustment is "well founded" and appropriate in amount. In this way, a MAP will be available to relieve economic double taxation. However, even when, in general, a State is willing to agree to a corresponding adjustment, Article 9 (3) of the United Nations Model Convention provides that no such adjustment is required if one of the parties involved in the primary adjustment is liable for a penalty based on fraud, gross negligence or wilful default.

Some treaties, especially those signed before 1977, do not contain Article 9 (2). Nonetheless, paragraph 9 of the Commentary to Article 25 of the United Nations Model Convention, quoting paragraph 11 of the Commentary on Article 25 of the OECD Model Convention, takes the position that economic double taxation resulting from transfer pricing adjustments is not within the "spirit" of the treaty and thus should fall within the scope of MAP even in the absence of Article 9 (2) in the treaty. Not all States share this view and this is a point which

request a MAP from its State of residence. If State P, in fact, agreed with the primary adjustment proposed by State S, it could deal with the resulting economic double taxation by making a corresponding adjustment unilaterally, as is provided for in Article 25. If, as is more likely, it does not agree with the adjustment, State P would then be obligated to contact State S to begin bilateral consultations. Similarly, S Co., the taxpayer to whom the primary adjustment has been made, could also make a request for a MAP to State S, again on the basis of the economic double taxation arising from the adjustment. In transfer pricing cases, therefore, the administrative procedures must be adapted to the situations in which both taxpayers have the right to request a MAP.

3. General "best practices" in structuring a MAP

Both the United Nations Guide to the Mutual Agreement Procedure under Tax Treaties (United Nations Guide to the MAP) and the OECD Manual on E ective Mutual Agreement Procedures (MEMAP) provide very useful guidance in structuring and implementing MAP. is guidance is framed in terms of best practices and is distilled from the experience with MAP of both developed and developing countries. e recommendations, of course, must be evaluated in the light of each country's background and context, but they provide valuable insights

3.2 Competent authorities should make every effort to resolve cases on a principled and fair basis (United Nations Guide to the MAP, paragraph 49)

It is important that the competent authorities approach each case on the basis of a principled and consistent view of its facts and circumstances and the applicable legal and economic principles. Each case should be decided on the basis of its own merits and, thus, the same principles may generate different results in different cases. The role of the competent authorities is to achieve a solution to the case which resolves the issue of potential double taxation and not to merely attempt to find the most advantageous resolution from the revenue point of view. Flexibility may be needed to achieve an appropriate compromise in a given case.

3.3 Audit settlements should not require the taxpayer to relinquish subsequent recourse to a MAP (United Nations Guide to the MAP, paragraph 80)

In some jurisdictions, it is often a practice to include in an audit settlement an agreement by the taxpayer not to seek MAP relief after the settlement. In effect, two parties, the taxpayer and one tax administration, thus exclude the other tax administration from a consideration of the case. This may lead to double taxation and the development of inappropriate principles on the basis of which cases are settled, causing in the long run a system in which cooperation in the appropriate resolution of international double taxation is impeded.

3.4 Separation of the MAP and audit functions (United Nations Guide to the MAP, paragraph 62)

While there are many ways to organize a MAP function which fit within the overall structure of the tax administration, it has been found to be desirable to separate the MAP and audit and assessment functions. It is important that the MAP function be independent and objective, with a focus on applying the treaty and relieving international double taxation. This requires a somewhat different "mind-set" from an auditor, whose principal job focus and relation to the taxpayer

tend to be somewhat di erent. e criteria for assessing a successful MAP function should be in terms of the time to resolve cases, and the achievement of principled and objective outcomes and not, for example, the amount of revenue collected.

3.5 Liberal use of the MAP under Article 25 (3) (MEMAP, Best Practice 1)

While, in practice, most MAP activity involves taxpayer-initiated MAP seeking relief from taxation not in accordance with the treaty, it is also important that the competent authorities take full advantage of the authority they have, under Article 25 (3) of the United Nations Model Convention, to issue guidance and interpretations of general application. is can help avoid unnecessary disputes later over such matters in the context of a concrete case and allows taxpayers to better organize their a airs.

4. Arbitration under Article 25 (5)

4.1 Introduction

Article 25 (2) of both the United Nations and OECD Model Conventions establishes that, when presented with a taxpayer-initiated MAP request, the obligation of the competent authorities is that they "shall endeavour" to resolve the case under the MAP. While the competent authorities will make every e ort to resolve the case on a principled
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the competent authorities will proceed to arrive at a MAP which will ensure that taxation is carried out in accordance with the treaty. e details of the OECD procedure and its relation to the United Nations Model Convention are discussed below, but it is important to observe at the outset that the arbitration procedure outlined in the OECD Model Convention is not in any sense an alternative to the MAP, rather it provides a mechanism for supplementing it and allowing it to more

arbitration but postpone its entry into force until each country has noti ed the other that the provision should

Members of the Committee in favour of alternative B pointed mainly to the following considerations and arguments:

- despite the fact that only a small number of cases remain unresolved, each of these cases represents a situation where there is no resolution for a case where one competent authority considers that there is taxation not in accordance with the Convention and where there may be signi cant double taxation;
- arbitration provides more certainty to taxpayers that their cases can be resolved under the mutual agreement procedure and contributes to cross-border investment;
- domestic remedies may nottbrvvrd20(r)-1(e)q--nar ay(o)d205(e)]TJu0.0

- it is in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration."

us, each country must consider the factors outlined above in developing its own approach to arbitration. In some cases, national law, policy or constitutional provisions may raise questions as to the ability of the State to enter into treaties which contain an arbitration provision, and these factors must be considered as well.

Since the introduction of the OECD provision in 2010, a growing number of countries, including developing countries, have been including some form of arbitration clause in their treaties and this increased experience should also be taken into consideration. Some treaties which have no arbitration clause require that if the treaty partner enters into a treaty with another partner which does have an arbitration clause, then that issue must be reopened in the existing treaty without further formalities being required.Di Tw 2.7on.7oqn10(e24(y17(n(g)1h t)t

4.3.2 Who submits the case to arbitration?

Under the OECD approach, it is the taxpayer who has the right to require that the unresolved issues in the case must be submitted to arbitration. In the United Nations version, the case is submitted to arbitration if one competent authority wishes to have the case arbitrated. us, if both competent authorities do not want to have the case go forward to arbitration, they can prevent a nal resolution of the case and it will go undecided and result in double taxation. In this regard, the United Nations procedure is, from the point of view of the taxpayer, not truly mandatory.

4.3.3 Finality of decision

Under the OECD Model Convention, once the arbitration decision has been reached and communicated to the competent authorities, they are required to follow the decision and reach a MAP. Under the United Nations provision, modelled on a similar provision in the European Union Arbitration Convention, the competent authorities can deviate from the decision of the arbitrators if they can reach an agreement within six months of the arbitration agreement. us, they are still required to reach an agreement, but it can di er in result from the agreement which would have been based on the arbitration decision.

4.3.4. Form of decision

Both the United Nations and OECD Model Conventions have published a Sample Mutual Agreement on Arbitration (Sample Agreement), which sets out many of the technical and procedural aspects of the arbitration procedure. Under the OECD approach, the "default" or generally applicable rule is that the arbitrators must give a reasoned opinion for their decision. ere is an alternative "streamlined" form of decision which is based on the so-called "last best o er" or "baseball" approach, under which each competent authority submits its desired result and the arbitrator simply picks one or the other of the two options without any reasoned opinion justifying the result. In the United Nations Sample Agreement, the "last best o er" approach is the base rule, although the competent authority can elect to use the "independent" format.

Hugh J. Ault

4.4 Basic features of the United Nations

4.4.3 Relation between arbitration and domestic legal proceedings

Article 25 (5) of both the United Nations and OECD Model Conventions expressly excludes from arbitration any issue on which a court or administrative tribunal in either State has already given a decision. is restriction is necessary because, in most countries, the competent authorities are not in a position to e ectively overrule a court decision. In such a situation, the competent authorities would not be in a position to implement a MAP based on an arbitration decision which deviated from the court decision. In countries where the competent authorities can deviate from a court decision in a MAP, this restriction may not be included in the text of Article 25.

With respect to ongoing domestic legal proceedings involving the issues in dispute, many States allow the proceedings to be suspended if a MAP is requested and then require the taxpayer to terminate the domestic procedures as a condition of accepting the MAP resolution of the case (see section 2.6.1). e same approach should be taken with respect to an agreement which has been reached by means of an arbitration of unresolved issues. A er arbitration, the taxpayer would be required to waive any existing claims under domestic legal proceedings and the accepted agreement would then be binding on both competent authorities and the taxpayer. Of course, for countries which require the waiver of domestic legal remedies as a condition for accepting a MAP request, the issue will not arise.

4.5 Procedural aspects of arbitration under Article 25 (alternative B)

4.5.1 General

ere are no procedural requirements in Article 25 (16.l

to the Sample Agreement used in the OECD Model Convention, but, Se _ Wf[a`W STahW[` eWf[a` &2/&1 fZW G`[fW @Sf[a`e ES_ bW Agreement uses the "last best o er" approach as the basic format for the proceedings, though the competent authorities can agree to use an "independent opinion" approach. In addition, it provides for a *de minimis* amount below which arbitration would not be available and also requires appointed arbitrators to certify their independence and impartiality.

4.5.1. The request for arbitration

Where the competent authorities have not been able to reach an agreement to resolve a case within three years from the time the case was presented by the taxpayer, one of them has the right to request that the unresolved issues be submitted to arbitration. is referral of unresolved issues to arbitration is mandatory and does not depend on prior agreement of the other competent authority. As indicated above, the function of arbitration in Article 25 is not to decide the case itself, but only the issues that are preventing the competent authorities from coming to a mutual agreement. e introduction of arbitration enables the mutual agreement procedure to reach a satisfactory resolution of the case, which is being blocked by the failure to agree on certain issues.

4.5.2 Terms of Reference

e Terms of Reference establish the jurisdictional base for the arbitration process and set out the issues to be decided in the arbitral process. e competent authorities are required to establish the Terms of Reference within three months of the request for arbitration.[21] e Terms of Reference may also provide additional procedural rules to govern the arbitration process. e Terms of Reference are to be communicated to the person who has presented the case, who would presumably have been consulted on their formulation.

[21]Paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 2 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention, quoting paragraph 1 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

4.5.3 Appointment of arbitrators

A er the Terms of Reference have been established and communicated to the person who has presented the case, the competent authorities have three months to each appoint an arbitrator.[22] e Sample Agreement does not set out any special quali cations for the arbitrators, on the assumption that all of the parties will be interested in appointing quali ed persons. Government o cials may be appointed as long as the o cial was not directly involved in prior stages of the case. As a default rule to deal with the situation where one of the competent authorities has not made a timely appointment, the Sample Agreement gives authority to the Chair of the United Nations Committee of Experts on International Cooperation in Tax Matters to make the appointment.[23]
A er their appointment, the two designated arbitrators.112 Tw 0.119 .39 ST-

4.5.4 Participation of the taxpayer

The arbitration foreseen in Article 25 (5) is structured as an extension of the mutual agreement procedure. As this is basically a government-to-government procedure aimed at a consistent application of the treaty, the taxpayer's right to participate in the process is correspondingly limited. Thus, the Sample Agreement provides that the taxpayer shall have the same rights to present its case in writing to the arbitrators as it would have in a MAP. The Sample Agreement does foresee, however, that, with the permission of the arbitrators, an oral presentation may be made. This limited degree of participation is consistent with the fact that the taxpayer, at the conclusion of the proceeding, has the right to reject the final agreement which is based on the arbitral decision. The process of reaching a decision is basically up to the competent authorities.

4.5.5 The arbitral decision

As indicated above, the United Nations version of the Sample Agreement takes as its default position for the arbitral procedure the so-called "last best offer" approach. Under this approach, each competent authority makes a proposal for the resolution of the issue in dispute to the arbitral board and the board chooses one or the other of those proposals. The arbitrators are given only a limited time to make the decision and do not give a full written explanation of the decision but only "short reasons" explaining the choice.[25] The United Nations Committee of Experts on International Cooperation in Tax Matters selected this approach as it is quicker and less costly. However, the Terms of Reference may allow the competent authorities to select an "independent opinion" if they wish. This approach has the advantage of providing a fuller explanation of the decision and gives the possibility for the decision being a guide to the settlement of future cases involving the same issue. If an independent opinion approach is taken, it would also be possible, with the approval of both the competent authorities and the taxpayer to publish a redacted version of the decision. This too would help resolve cases in the future.

[25] See paragraph 6 of the Sample Agreement included under paragraph 2 of the Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention.

4.5.6 Implementation of the decision

After the arbitration procedure has resolved the issues which were preventing the issuance of an agreement, the case is returned to the competent authorities. Under the United Nations Model Convention, after the decision has been communicated to the competent authorities, they still have a six-month period in which they can agree to a different solution than that arrived at by the arbitration panel, as long as that solution comes to a common understanding of the application and interpretation of the convention.

4.5.7 Costs

additional information from the taxpayer as to the functions carried out in State S, the assets involved there and the risks assumed. After additional negotiations, they enter into a MAP that State S is entitled to tax 15 of profits. The taxpayer has the choice of either accepting the MAP and the allocation of profits agreed by the competent authorities or, if it has appropriately secured its rights to judicial remedies in State S, to attempt to obtain a judicial determination in State S that there was no permanent establishment or that less profit should be been allocated to State S. Assuming that Company R prefers to accept the MAP, it must waive any rights to further legal remedies in State R and State S. Company R would then be entitled to a refund of tax from State R on the 15 of profit already taxed there and would have a tax liability on the 15 of profits not reported in State S. Depending on the domestic rules of State R and State S, Company R would owe interest on the liability in State S and be entitled to interest on the refund from State R. The MAP may have been able to deal with the interest issues as well.

Scenario C

The facts are the same as in scenario B above, except three years have passed since Company R has presented its case and the competent authorities of State R and State S have still not been able to resolve the case. If the treaty between Country R and Country S followed alternative B of Article 25 of the United Nations Model Convention, one of the competent authorities could request that the unresolved issues in the case could be submitted to arbitration, assuming that there is no prior decision by the courts or administrative authorities of either State in the case.

Example 2: Article 9 MAP case

Company R in State R produces cars at a cost of 100 and sells them to Company S, a wholly-owned State S subsidiary organized in State S, at a price of 150, declaring and paying tax on a profit of 50 in Country R. Company S buys the cars for 150 and sells them for 175, declaring a profit and paying tax on 25 to State S. Country S audits Company S and proposes to adjust the price that S paid for the cars to 125 on

the basis of Article 9 of the relevant treaty, claiming that the transfer price of 150 was not at arm's length. The treaty between Country S and Country R follows the United Nations Model Convention and contains Article 9 (2). As a result, there is economic double taxation, as 25 of profit is being taxed both in State R and State S, though to different taxpayers.

Company R could make a claim under Article 25 (1) of the United Nations Model Convention and make a request to State R to make a "corresponding" or "correlative" adjustment reducing its profits by 25, corresponding to the "primary" adjustment made by State S in the profits of Company S. If Country R agreed with the Country S determination of the transfer price, it could make a unilateral resolution of the case.

However, State R is only required to make a unilateral corresponding adjustment if it finds that the Country S primary adjustment was "justified both in principle and as regards amount". Assuming that Country R does not agree with the determination of the transfer price by Country S, it would then begin the process of bilateral negotiations described in section 2.5 above.

Assuming that Country S and Country R agree after negotiations that the appropriate transfer price was 135 and that Company R and Company S agreed with that result, an agreement to that effect could be implemented by reducing the tax of Company R and correspondingly increasing the tax on Company S. The agreement may also treat the question of interest in both States. However, after this adjustment, Company R still has received 15 too much cash from

Chapter IX

Exchange of information

Diane M. Ring*

1. Introduction

Exchange of tax information has become one of the most commonly

discussion and practice, a working knowledge of the various mechanisms of information exchange, and an appreciation of the issues and concerns that may be of particular interest to developing countries. Moreover, developing countries need to consider what is necessary for them to comply with their obligation to exchange information, how exchange of information may be bene cial to their own jurisdictions, and what features of such an agreement are most critical for them.

At its broadest level, information exchange refers to the exchange of tax information (either taxpayer-speci c information, or more general tax-related information) by one country to another, to aid the requesting jurisdiction[4] in implementing and administering its tax laws. Exchange of information can only take place pursuant to an existing agreement between the two jurisdictions (such as, but not limited to, a bilateral double tax treaty) that contains a provision authorizing the exchange of information. Beyond this basic description of information exchange are many details crucial to the functioning and scope of an exchange of information provision. As discussed in this chapter, there are model agreements and provisions available to serve as a starting point for countries seeking to negotiate an agreement to provide for information exchange. However, countries should be sensitive to the range of variations in such provisions. e commentaries accompanying the di erent models provide a good source for reviewing and assessing much of this potential variation.

2. Overview of information exchange

2.1 Core features

A review of information exchange can be roughly divided into three core features: (a) the legal framework under which exchange of information will take place (the terms of the agreement and the rights and responsibilities of the signatories); (b) a country's domestic infrastructure relevant to information exchange (legal, regulatory,

[4]In this chapter, the country asking another country for information is referred to as the "requesting State" and the country that is asked to provide the information is referred to as the "requested State."

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to say, for which taxes can information be exchanged to assist in the administration and enforcement of tax laws); (b) for which taxpayers can information be requested/received; (c) how a decision to exchange information is made (that is to say, on the basis of a request by one country, through an automatic exchange process, or spontaneously by the country having the information); (d) what information a State requesting it must provide in order to be able to secure an exchange under the agreement; (e) in what form will information be transmitted; (f) what duties does the requested State have to search for information that is not readily available; (g) under what circumstances can a country refuse to exchange information when a request is made pursuant to an applicable agreement; (h) what are the limits on the requesting State's use of the information; (i) what are the duties of the requesting State regarding the information received (that is to say, duties to pro-

the domestic infrastructure of jurisdictions and assess the degree to which they are compatible with an e ective exchange of information and, if not, what changes would be recommended. ree examples can illustrate this point.

First, if a country has domestic rules requiring bank secrecy, it cannot ful l its obligations under the typical modern agreement that requires exchange of information regardless of domestic regulations, law, practices or requirements grounded in bank secrecy. e country will need to implement domestic level changes in its bank secrecy rules in order to e ectively participate under an agreement providing for meaningful information exchange. Second, if a country does not currently have domestic rules and procedures in place to protect taxpayer information, the development of such rules and procedures will be essential to meeting the country's duties under any agreement to safeguard tax information received from another State. ird, depending on a State's current level of experience, technology, sta ng and expertise in its tax administrative o ces, there may be some di culty in acquiring, organizing, sharing and making use of taxpayer information. A variety of resources (including those o ered by international organizations) are directed at helping countries build their tax administration capacity so that they can be more e ective in the management of their entire tax system, including their ability to exchange information and receive information in a productive manner.

2.1.3 Compliance with/implementation of an agreement to exchange information

Ultimately, entering into agreements to exchange tax information has little impact if the exchange provisions are not used, or if requests for information are routinely discouraged, either directly or indirectly (for example, through delay, poor quality data, or baseless challenges to requests). States should consider whether they and their partners under the agreements are committed to the process and goals of information exchange. is commitment will be re ected in how the exchange provisions of the agreement are dra ed, in how States seek to ensure that they are domestically able to perform under the agree-

2.2 Major issues

Several key issues run throughout the three major components of

delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange.”

2.2.3 Realistic capacity

ere can be an absence of e ective information exchange through less intentional barriers, including the administrative limits of a country’s domestic tax system and tax administration. e Commentary on Article 26 of the United Nations Model Convention provides that a developed country may not “refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country.”[8]

2.2.4 Realistic ability to benefit

Developing countries in particular may be concerned about their ability to bene t from an agreement that includes information exchange. It will be important for such countries to bear this point in mind when negotiating agreements and when seeking to improve domestic tax administrative capacity.

2.2.5 Cost and balance

Compliance with exchange of information requests is not costless. In a double tax treaty, States typically consider the relative balance between the two contracting States of both the individual provisions and the treaty as a whole. With respect to a provision on exchange of information, if the requests for information are generally balanced, the cost dimension is a less prominent issue. But where there is a likely imbalance of requests (for example, one State making many more requests for information than the other) and/or where one of the contracting States has more limited administrative capacity, the question of cost or burden becomes relevant. is situation is more likely in the context of an agreement between a developed and a developing country. States can respond to this risk in making design choices about their exchange

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[8]Paragraph 1.3 of the Commentary on Article 26 of the United Nations Model Convention.

of information provision and in developing a stronger infrastructure (which could enhance both the ability to provide information and the ability to use information).

2.3 Options for information exchange

Although an agreement between the two States seeking to exchange information is a necessary predicate for the exchange of information, there are several different legal mechanisms available. First, bilateral double tax treaties typically have an exchange of information provision (such as Article 26 of the United Nations Model Convention). It is important to carefully review the terms of older bilateral double treaties. Provisions drafted years ago may not contain some of the key language seen today that seeks to ensure more effective exchange of information. For example, older provisions may not be as clear on whether a jurisdiction can rely on a domestic bank secrecy rule to refuse to comply with a request for information.

Second, bilateral Tax Information Exchange Agreements (TIEAs) can also serve as the legal basis for information exchange. It is very important to be clear about the limited scope of TIEAs. Unlike bilateral double tax treaties, TIEAs only address exchange of information. They do not cover the other subjects typically found in a double tax treaty. TIEAs are examined in further detail in section 5.2.

Third, a variety of multilateral agreements can also support information exchange. Such multilateral agreements include the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (discussed in section 5.3) and various regional multilateral SYdWW Wfe (V[eUgeeW [` eWf[a` ' ž&)ž

3. Contemporary context of information exchange

chapter, it is necessary to review the background against which this Article and its Commentary was developed.

e report continued on to discuss the impact of bank secrecy practices and rules on the e ective exchange of information:

> " e limited access that certain countries have to bank information for tax purposes (*e.g.*, because of bank secrecy rules) is increasingly inadequate to detect and to prevent the abuse of harmful preferential tax regimes by taxpayers. e Committee has commissioned a survey of country practices regarding access to bank information for tax purposes."[12]

failed to report their income to their residence jurisdiction. However, objections to such exchange of information (grounded in part on bank secrecy laws) were raised by several States. e agreed solution which was provided by the 2003 EU Council Directive on taxation of savings income in the form of interest payments[15] allowed Austria, Belgium and Luxembourg to withhold tax for the residence jurisdiction instead of providing information to that jurisdiction. is option was to be available for a "transitional period", on the acknowledgment that withholding is not an adequate substitute for information exchange, because it fails to ensure that the residence jurisdiction is aware of the principal amount in the account (which may never have been reported by the taxpayer).

3.3 The bank secrecy crisis and the rise of TIEAs

Although some movement was taking place on exchange of information issues during the rst half of the 2000s, the tenor of the conversation shi ed dramatically in 2008 with the public eruption of a couple of very high-pro le tax evasion scandals in Europe. ese scandals changed the public perception of banking secrecy from one centered on nancial privacy and security to one grounded in a picture of fraudulent (and o en criminal) evasion of residence country taxation made possible by the banks' concerted and knowing e orts.

In the years following these scandals, a dramatically increasing number of TIEAs have been signed. Fewer than 30 had been signed before the scandals; by 2012, over 500 had been signed, although the signi cance of the total numbers requires some scrutiny (some countries, frequently identi ed as "tax havens", in fact, have signed TIEAs with other "tax havens", rather than with major capital exporting jurisdictions). Relatedly, the Global Forum on Transparency and Exchange of Information for Tax Purposes (an evolution of an earlier OECD working group and forum activity, which now has approximately 120 members) began to engage in peer review of countries' domestic rules and practices relevant to transparency and exchange of information.

[15] 5ag`U[^6[dWf[hW$""%&*!75 a` fSjSf[a` aXeSh[`Ye [`Ua_W[` fZW form of interest payments, 3 June 2003.

4. Exchange of information under Article 26 of the United Nations Model Convention

4.1 Introduction

e purpose of Article 26 of the United Nations Model Convention is to provide an explicit framework (within the context of a bilateral double tax treaty) for the circumstances under which a treaty partner may request or receive information from the other partner, which would be useful or relevant in helping to administer or enforce the requesting country's domestic tax rules or treaty terms. Although Article 26 has been modi ed as recently as 2011 to provide increased clarity on certain points, its accompanying Commentary is invaluable in providing additional details, examples, and alternative language.

4.1.1 Reasons for exchanging information

Before considering the details of the double tax treaty's exchange of information regime, it is important to be clear about why countries might want to exchange information. is knowledge would be relevant in both evaluating their commitment to the process, as well as the kinds of information that they would want to be able to e ectively secure and use. e exchange of information process can provide countries with access to information regarding the assets, accounts and income of their taxpayers held in another jurisdiction. Such information is especially valuable when those taxpayers have not reported the income, or information, domestically, as otherwise required. Although this use of exchanged information may be most prominent today given the banking scandals, there are a variety of other contexts in which States may seek information to more e ectively implement their own tax laws. A country may seek to verify whether deductions sought by the taxpayer against domestic taxation are valid. Alternatively, a requesting State may be trying to determine whether a taxpayer is in fact a resident of the treaty partner, or owns certain entities or assets, or is meaningfully engaged in a transaction such that the country should respect the transaction as reported by the taxpayer. Any information on these points could signi cantly alter the tax treatment that the requesting State would consider appropriate under its laws.

(a) Simultaneous audit:

(b) Joint audit:

In the case of a joint audit, the audit itself is a single process performed jointly by the participating States. It requires a dif-

4.1.2 Expectations of information exchange under Article 26

e Commentary on Article 26 of the United Nations Model Convention
is explicit in establishing the tenor for how the provision is tisiJu/T1iosorrTw 0.111

which bars bank secrecy from serving as a justification for refusal to exchange information. As the Commentary to Article 26 of the Model Convention suggests, countries may have differing views on whether these 2011 changes to that Article are substantive or interpretive.

4.2.1 The basic questions of information exchange

As was reviewed in section 2.1.1, provisions such as Article 26 of the United Nations Model Convention provide all the legal details underlying the exchange process. But there are four basic questions that set the contours of exchange of information: (a) Who can request information? (b) About whom can information be requested? (c) What information can be requested? (d) With respect to which taxes can information be requested? The language of both Article 26 and the Commentary are clear on these points. The competent authorities of the two contracting States serve as the points of communication for information exchange. Thus, it is the competent authority of a requesting State which communicates the request — and this request is communicated to the competent authority of the requested State. Furthermore, the two competent authorities, pursuant to Article 26 (6) of the United Nations Model Convention, can together agree upon "methods and techniques" regarding the actual exchange of information.

The next important question concerns about whom information can be sought. Paragraph 8.2 of the Commentary on Article 26 of the United Nations Model Convention explicitly states that the subject of the information request need not be a resident or a person engaged in economic activity in the requested State. One example in the Commentary is particularly interesting in light of the recent focus on tax evasion and offshore bank accounts. Paragraph 8.2 of the Commentary on Article 26 of the United Nations Model Convention offers as an example of an appropriate request one in which the requesting State seeks information regarding a bank account held in the requested State by a person who is not a resident of either the requested State or the requesting State. Thus, information exchange is not limited to information regarding persons covered by Article 1 of the treaty.

The third basic question, regarding the type of information that can be requested, was the subject of some of the 2011 changes to Article

26. In 2011, language in Article 26 (1) was changed from information that was "necessary" for carrying out the provisions of the treaty or the administration of domestic law to information that is "foreseeably relevant" for those purposes. e explicit purpose of the current language is to clarify that the requesting State need not demonstrate its need for the information before the requested State has a duty to provide it. is 2011 change is characterized in the Commentary as one that is not substantive, but rather serves to "remove doubts" and "clarify" the prior language.[24]

e Commentary also gives conete eta(e)C4pree of the 11(t)-31(t8-23(3t)

e fourth question concerns the type of taxes covered (that is to say, the taxes for which an information request can be made). As with the question of who is covered, the question of the taxes covered by an Article 26 request is broader than the list of taxes that are usually the subject of the double tax treaty. us, a State can not only request information relevant to the application of the treaty itself, or to domestic taxes identi ed in Article 2, but also request information pertinent to all other domestic taxes (including subnational taxes).[27] e dra - ing option provided by the Commentary for this part of Article 26 (1) re ects the reality that the otherwise broad scope of taxes covered may be either burdensome or legally di cult for some States. In such cases, the Commentary provides for alternative language that limits the covered taxes to the Convention itself and to other taxes listed by the contracting States.[28]

4.2.2 Examples of information that could be exchanged pursuant to Article 26

(a) Financial intermediaries:

A nancial intermediary (FI) invests the money of its account holders in State A, which requires recordkeeping regarding bene cial ownership, but does not regularly request those records for domestic law enforcement. State B suspects that some bene ciaries of the account holders of the FI are State B residents. State B may request State A to obtain information on identi ed taxpayers fr1 Tmu( )85n1.003 Tw0(l o)19(It(.)]TJu/Bt(. 1 Tfu0.02389.546 23

request that State A provide information regarding the pro ts and expenses of the State C subsidiary. Domestic law of State A obliges a parent company to keep records of foreign subsidiary transactions.[30]

(c)

request should be considered against the backdrop of experience with Article 26 in practice. In particular, countries have relied on a variety of arguments, including bank or nancial secrecy, to reject a request for information.

Article 26 (3) itself includes three basic subparagraphs noting circumstances under which compliance with a request is not required: (a) where compliance is "at variance with the laws and administrative practice" of the requested or requesting State; (b) where information is "not obtainable under the laws or in the ordinary course of the administration" of the requested or requesting State; and (c) where compliance would disclose trade secrets etc., or be contrary to public policy. e Commentary is important in providing the necessary context for the meaning and scope of these exceptions, how they should be applied and the range of contexts in which exchange cannot be refused.

First, a State may refuse to provide the information in the speci c form requested if that form is not "known or permitted under its law or administrative practice."[33] However, to limit the use of this objection, the Commentary con rms that refusing to comply with a request to provide information in a particular form does not excuse the requested State from providing the information at all.

e next aspect dealt with is particularly nuanced. States are

What then would be appropriate circumstances in which a State could decline to provide information because of a domestic law/administrative practice con ict? An example of appropriate refusal on the grounds of con ict with domestic law may be the case where, under its own laws, the requested State is not permitted to seize private papers from a taxpayer without court permission. e requested State need not perform a seizure without court permission to meet a treaty information request—

that genuine attorney-client communications will be protected from an information exchange request where they would otherwise be protected under the requested State's law.[38]

The Commentary advises States that the "trade secrets" exception in Article 26 (3) (c) should not be construed broadly, because that would conflict with the core vision of Article 26. Thus, a State should not refrain from providing, or decline to disclose, information because this might be embarrassing, generate bad publicity or increase taxes. Nor does the trade secrets exception generally cover financial information. Furthermore, the status of information as "secret" is not, in itself, a bar to disclosure. A State may disclose secret information if the requested State concludes that disclosure to the public or competitors is unlikely because of the confidentiality provision in Article 26 (2), which places a duty on the requesting State to protect information received and use it only in certain ways.[39]

4.2.4 Objections to exchanging information — Inappropriate grounds

Article 26 and its Commentary not only seek to clarify what are good reasons for declining to provide information, but they also seek to clarify those which are not. The most prominent change in this regard is the new language in Article 26 (5), introduced in 2011. Under this language, States are barred from relying on bank secrecy to decline to provide information. Thus, Article 26 (5) operates as an override to Article 26 (3), to the extent that bank secrecy was the justification offered under Article 26 (3). For some States, this change to Article 26 will be an important and substantive one.[40]

An example of inappropriate refusal to exchange information on the grounds of bank secrecy may occur where a taxpayer subject to tax in State A has a bank account with a bank in State B and State A — in

[38]Paragraph 27.7 of the Commentary on Article 26 of the United Nations Model Convention.

[39]Paragraphs 22.1, 22.2 and 22.3 of the Commentary on Article 26 of the United Nations Model Convention.

[40]Paragraphs 4.1, 27.2 and 27.3 of the Commentary on Article 26 of the United Nations Model Convention.

the context of examining the taxpayer's individual return — requests that State B provide "all bank account income and asset information" held by the bank. State B cannot refuse on the grounds of its bank secrecy laws and should comply with the request.[41]

Similarly, Article 26 is also quite explicit about the invalidity of another argument against exchanging information — that the information concerns a person not resident in either contracting State. Article 26 (1) clearly rejects this possible argument.

One issue that has emerged in the context of refusal to provide information is the importance and role of criminal conduct in either

Finally, Article 26 (4) is explicit in providing that a State cannot decline to provide information on the grounds that it has no use for that information. This 2011 addition to the United Nations Model Convention was, according to the Commentary, taken directly from the OECD Model Convention.[43] The Commentary notes a concern that some contracting States might argue that they are not legally capable of providing information that they do not themselves need for tax purposes (despite the language in Article 26 (4)). As a response to this concern, the Commentary provides alternative treaty language. This alternative wording explicitly requires that each contracting State must undertake to ensure, through legislation, rulemaking or administrative steps, that its competent authority will have adequate powers under domestic law to secure information for treaty exchange purposes.[44]

4.2.5 Data protection

Not surprisingly, if States are surrendering information on taxpayers to another jurisdiction, they may have some interest in ensuring how that information will be used and disseminated. What are these States concerned about? Risks range from "benign" business concerns (that the information will be made available to competitors of the taxpayers) to more serious abuses (that the tax and financial information will be used to facilitate criminal conduct and/or threaten or harass the taxpayer). Article 26 (2) speaks directly to data protection, requiring the requesting State to treat the information received as confidential in the same manner it does with information secured domestically. Furthermore, the Article provides additional specificity by limiting disclosure of the received information only to persons "concerned with the assessment or collection of, the enforcement or prosecution … or oversight" of the taxes enumerated in Article 1. These persons to whom information has been disclosed under the treaty may use the information solely for these tax related purposes. The treaty language in Article 26 (2) does contemplate disclosure of the exchanged

[43] Paragraph 26 of the Commentary on Article 26 of the United Nations Model Convention.

[44] Paragraph 26.3 of the Commentary on Article 26 of the United Nations Model Convention.

information in “public court proceedings or in judicial decisions”. e Commentary identi es several points upon which States may seek to clarify the language in their treaty, either for purposes of restricting the scope of Article 26 (2) or expanding its use. Speci cally, States may wish to: (a) object, in the bilateral treaty, to exchanged information being made public by courts; (b) allow expressly, in the bilateral treaty, for exchanged information to be shared with a third country; or (c) provide a mechanism for allowing the exchanged information to be used by the requesting State for other purposes. It should also be anticipated that the details surrounding the technical mechanisms by which information is exchanged and delivered (for example, by electronic data systems) will be developed by the competent authorities with attention to data protection issues.[45]

4.2.6 How information can be exchanged

One central operating question regarding information exchange is how this exchange process will take place. Much of the real e ect of a treaty’s information exchange provision turns on the implementation choices made under the treaty and under the competent authority negotiations on the details of information exchange. As an initial matter, Article 26 (6) of the United Nations Model Convention directs the competent authorities to develop jointly the methods and techniques for information exchange. is provision does not appear in the OECD Model Convention directly, but it is presumed.

ere are three basic ways to exchange information: (a) on request; (b) routine/automatic exchange; and (c) spontaneous exchange. e language of Article 26 clearly contemplates information exchange za` dWgWefŠ Sf S _ [` [_ g_ ž8ad VjS_ bWW3 df[UWS((& TW[` ei [fZ the language: “[i]f information is requested by a contracting State”. Recognizing that information exchange would at least cover this category, but might not extend to the other two, the Commentary provides alternative language to add to the end of Article 26 (6). is language would clarify that the contracting States were agreeing to exchange on request, and also to automatic and spontaneous exchanges as

[&] Paragraphs 5.2, 12.2, 13.2 and 13.3 of the Commentary on Article 26 of the United Nations Model Convention.

established by the competent authorities.[46] As indicated above in sections 1 and 2.1, there is a strong movement toward making greater use of automatic exchange, which is rapidly becoming the international standard. is is an important factor for developing countries to keep in mind in structuring treaty and domestic law exchange provisions.

As both the United Nations Model Convention and countries' treaty practices continue to encourage meaningful exchange of information, a serious concern arises regarding burdens imposed on the requested State, particularly when that State is a developing country. Compliance with a request or series of requests may be burdensome, at least relative to the tax administration's capacity in the requested State. e Commentary recognizes this risk:

> "Some members of the Committee have expressed a concern that information requests from a developed country to a developing country could place excessive burdens on the tax department in the developing country due to the di erent capacity of their tax administrations to obtain and provide information. at concern might be alleviated by making the requesting State responsible for material extraordinary costs associated with a request for information. In this context, the question of whether an extraordinary cost of obtaining requested informa

> requests the information. e competent authorities of the Contracting Parties shall consult with each other in advance if the costs of providing information with respect to the speci c request are expected to be extraordinary."[48]

Although the Commentary does not provide an example of cost shi ing, such a scenario could include the following. Assume that State A, a developed country, makes a request under Article 26 of its bilateral double tax treaty with State B for information regarding certain taxpayers. State B, a developing country, incurs extraordinary costs in satisfying this request, including: (a) reasonable fees charged by third party experts to assist in meeting the request, and (b) litigation costs incurred by State B in responding to legal challenges initiated by nancial entities in State B in possession of data pertinent to State A's request. State B, pursuant to the additional language in Article 26 of its treaty with State A (and as further elaborated by any memoranda

On a very practical level, to participate in information exchange and other administrative provisions under the treaty, a State must designate who in its government (typically in the tax administration) will serve as its “competent authority”. e competent authority is the State’s representative working with its treaty partner in implementing the treaty, including the exchange of information provision. Typically, a request for information will not originate with the competent authority. Rather, someone in the tax administration (such as a tax auditor or examiner) will initiate the request. Each State will design its own

A few of the di erences between the United Nations and the OECD Model Conventions should be observed.

(a) Scope and purpose of exchange of information:

Article 26 of the United Nations Model Convention was revised in 2011 to explicitly state that information would be exchanged to help prevent "avoidance or evasion of … taxes." e di erence between avoidance and evasion has been a point of contention between some treaty partners in applying information exchange provisions. e language of Article 26 of the United Nations Model Convention was intended to clarify what existed in the Commentary—that addressing both problems is an appropriate goal for States and an appropriate role for exchange of information. Although the Commentary on Article 26 of the OECD Model Convention similarly identi es both avoidance and evasion as proper targets of State action, Article 26 of the OECD Model Convention does not have that explicit language.

(b) Type of information exchanged:

According to the Commentaries on Article 26 of both the United Nations and OECD Model Conventions, information exchange is not restricted to "taxpayer speci c information". us, information may be exchanged regarding abusive tax schemes, economic sectors or tax administration. One interesting point to note at this stage is that language was added to the OECD Commentary in July 2012[52] that allows "group identi cation" for an information exchange request. e United Nations Committee of Experts on International Cooperation in Tax Matters is currently considering exchange of information regarding groups of taxpayers and the related concern over " shing expeditions". A request for information regarding a "group" of taxpayers who are not individually named and identi ed has traditionally been viewed as problematic by some countries who fear that the exchange of information process

[52]As a technical matter, these changes are now part of the OECD Model Convention. However, they will not be published until the next update to the A756 ? aWW5a` hWf[a` S` V5a_ _ WfSdk [edWWeW (^[] Wk [` $"#&)ž

could be used for " shing expeditions" — to hunt for information without any speci c or clear idea of a taxpayer that would be the target of the requesting State's tax administration.   e OECD has sought to formulate a position that articulates when and how group requests would be appropriate.   e new 2012 OECD language quoted below may be useful in considering these questions:

"   e standard of 'foreseeable relevance' can be met

e potential for group identi cation could be very signi cant in making “on request” exchange of information more e ective

5. Other mechanisms for information exchange

5.1 Introduction

e increased attention to information exchange since 2002, and more speci cally since 2008, has resulted in the growth of other mechanisms (that is to say, other legal agreements) by which information can be provided or exchanged. In addition to the exchange of information provisions in bilateral double tax treaties, there are two other major categories of agreements regarding exchange of information: (a) Tax Information Exchange Agreements (TIEAs); and (b) multilateral agreements, including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[55] To some degree, TIEAs are the closest parallel to Article 26. In fact, one way to understand the role of TIEAs is to envision them as stand-alone agreements for exchange of information in cases in which the two States do not have (and may not have in the near future) a comprehensive bilateral tax treaty. Just because States do not have a full bilateral treaty does not mean that they would not have an interest in negotiating, and would not bene t from, an agreement exclusively addressing exchange of information. However, it is very important to acknowledge the limited scope of TIEAs. ey only cover information exchange, and not the wide array of other topics found in a bilateral double tax treaty.

5.2 Tax Information Exchange Agreements

As discussed in section 3.1, the OECD released a Model Agreement on Exchange of Information on Tax Matters in 2002.[56] For the next few years following its release, there was relatively little interest in executing these agreements and in fact few were signed. During this period, the newly created Global Forum on Transparency and Exchange of Information for Tax Purposes, a body that grew out of the earlier OECD

[55]OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

[56]OECD, Agreement on Exchange of Information on Tax Matters, 2002, available at http://www.oecd.org/ctp/exchange-of-tax-information/2082215.pdf.

circumstances under domestic law (Article 26 (3) (b) of the United Nations Model Convention; paragraph 18 of the Commentary on Article 26 of the United Nations Model Convention; Article 7 (1) of the OECD TIEA; paragraph 72 of Commentary on Article 7 of the OECD TIEA);

(h) Exception for trade secrets (Article 26 (3) (c) of the United Nations Model Convention; paragraph 18 of the Commentary on Article 26 of the United Nations Model Convention; Article 7 (1) of the OECD TIEA; paragraph 72 of the Commentary on Article 7 of the OECD TIEA);

(i) Contracting States are allowed to agree to a cost structure for requests beyond the ordinary (paragraph 29.3 of the Commentary on Article 26 of the United Nations Model Convention; Article 9 of the OECD TIEA; paragraph 98 of the Commentary on Article 9 of the OECD TIEA); and

(j) Coverage is not limited to residents of either contracting State (paragraph 2 of the Commentary on Article 26 of the United Nations Model Convention; paragraph 7 of the Commentary on Article 2 of the OECD TIEA).

However, there are some very signi cant di erences between TIEAs and Article 26 in a bilateral double tax treaty:

(a) e OECD TIEA is dra ed for both bilateral and multilateral cases (not just bilateral);

(b) e focus of the OECD TIEA is on "exchange upon request" and "does not cover automatic or spontaneous exchange of informationhan a bilateral d7si(a)r-(4b)10(_.5-17(n)(4g))7(t)-11(a)10

(d) e OECD TIEA is more detailed in identifying the type of information that the requesting State shall provide in making a request under the agreement (Article 5 (5) of the OECD TIEA).

TIEAs can be a viable alternative for States that do not already have a bilateral double tax treaty, and either do not intend to pursue one at this time, or are unlikely to reach agreement on the full range of topics covered by a bilateral double tax treaty at any point in the immediate future.

5.3 Multilateral Convention on Mutual Assistance in Tax Matters

e other notable agreement available to States that includes information exchange is the Multilateral Convention on Mutual Administrative Assistance in Tax Matters[57] (Multilateral Convention). It was developed by the OECD and the Council of Europe in 1998 and subsequently amended in 2011. It is now open to all countries. Over 50 countries have now signed the Multilateral Convention, including a number of developing countries, for example, Azerbaijan, Costa Rica, Ghana and Morocco. At this point, a key factor in the ability to rely on this Multilateral Convention is whether a particular State has signed and rati ed it, and whether the States from which the information is needed have also signed and rati ed it. Additionally, it is important to note that individual signatories can make reservations to the basic terms of the Multilateral Convention; thus, the precise provisions of it may not fully capture what the exchange of information relation-eZ[b i [fZ S ebWV[U\gd[eV[Uf[a` i ag'V ^aa] ^[] Vg`WVd [fž3 df[UW$& of the Multilateral Convention provides that signatories' competent authorities will establish the rules and procedures for implementing it as between two signatory States. e scope of the Multilateral Convention extends beyond information exchange to include forms of administrative assistance, including assistance in tax collection and simultaneous audits.

[57] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

taxpayers and third parties to provide additional information to the Government. FBAR is a reporting requirement imposed on parties who have some type of control over, or relationship to, a foreign bank account (not necessarily bene cial ownership). e core idea is that if the account is disclosed it is much easier for the tax administration to track down any corresponding income. FATCA, which has been enacted but is not yet in full e ect in 2013, is a regulatory regime imposed on certain "foreign nancial institutions" (FFIs) which requires them to provide information regarding United States taxpayers who have accounts at the FFI. Failure to provide this information to the United States can result in additional United States tax being imposed on certain income earned by the FFI itself in the United States. In the case of FATCA, the unilateral decision by the United States to implement a domestic regime has led, over the past year or so, to a multilateral response. A number of countries are signing Intergovernmental Agreements (IGAs) with the United States to establish a more realistic way for their resident FFIs to comply with FATCA. Perhaps of greater interest was the announcement in April 2013, that several European Union Member States were working together to develop their own agreement on nancial account information sharing, prompted by the FATCA legislation in the United States and by the bilateral IGAs that many countries are signing with the United States. All States should be attentive to increased e orts to use third parties (particularly nancial intermediaries) to provide information, particularly automatically generated and provided information.

(b) Voluntary disclosure program

States can, and do, implement programmes that encourage their own taxpayers to come forward and volunteer to disclose to the government their own failuosco, i

auditing that issue, and (b) a clear advantage to participants in the voluntary disclosure programme (for example, reduced penalties). What do governments get from voluntary disclosure programmes? Not only do they get information regarding the participating taxpayer, but also they can get (and may require)

Chapter X

Improper use of tax treaties, tax avoidance and tax evasion

Philip Baker*

1. Introduction

is chapter focuses on several issues, all of them linked to the theme of tax avoidance. In summary, it deals with the following:

¾ How to prevent tax treaties from being used improperly as a basis for tax avoidance

¾ How to ensure that tax treaties do not prevent the e ective operation of domestic anti-avoidance rules

¾ How to use the administrative assistance provisions in tax treaties as an e ective mechanism to support the operation of domestic anti-avoidance rules.

ese main issues are considered in more detail below.

1.1 Preventing the improper use of tax treaties

Tax treaties o er a range of tax advantages which countries agree to grant to each other in order to prevent double taxation and eliminate the barrier that double taxation would create to cross-border trade, investment, movement of persons, etc. Examples of these tax advantages are: exemption from tax in one or other of the countries;[1] reduced withholding taxes on dividends, interest and royalties;[2] and

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[1]For example, under Article 13 (6) of the United Nations Model Double Taxation Convention between Developed and Developing Countries (New York: United Nations, 2011) (United Nations Model Convention).

[2]Under Articles 10, 11 and 12 of the United Nations Model Convention.

a foreign tax credit or exemption to eliminate double taxation.[3] ese tax advantages are liable to attract the attention of tax planners. For the countries concerned, it is a matter of ensuring that the tax treaty is not improperly used and that the tax advantage does not operate to the bene t of persons for whom it is not intended. At the same time, however, it is important that the tax advantage is granted to those who are genuinely entitled to it; to refuse the tax advantage in cases where there is no improper use of the tax treaty would defeat the objective of the two countries in entering into it.

1.2 The relationship between domestic anti-avoidance rules and tax treaty provisions

All tax systems will contain some speci c, and o en some general, anti-avoidance rules. In a cross-border context these rules might sometimes operate to tax a transaction where a provision in a tax treaty would have the e ect of preventing the tax being imposed. For example, where a taxpayer has arti cially transferred a source of income to a resident of another country, anti-avoidance legislation[4] might allow the country from which the transfer has been made to continue to tax the income arising. However, a tax treaty may say that the income is taxable only in the other country, and this could be raised as a defence to the anti-avoidance legislation. If this has been deliberately planned, the use of the tax treaty to defeat the operation of a domestic anti-avoidance rule is an example of a form of tax treaty abuse.

1.3 Supplementing domestic anti-avoidance rules

Many domestic anti-avoidance rules can only operate e ectively if the revenue authorities know about the tax avoidance scheme or can collect accurate information about the income which is caught by the anti-avoidance rule. In a cross-border context, traditionally it would have been very di cult to obtain this information from another country. e provisions for administrative assistance by exchange of

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[3] Under Article 23 A or B of the United Nations Model Convention.

[4] For example, controlled foreign company legislation or transfer of assets abroad legislation.

information,[5] and sometimes by assistance in the collection of taxes,[6] may supplement the operation of domestic anti-avoidance rules so that they become more e ective.

1.4

> these circumstances would be contrary to the object and purpose of the relevant provisions."

e United Nations Committee of Experts on International Cooperation in Tax Matters endorsed that principle, and the Commentary explains[11] that two elements must be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of the tax treaty: (a) a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position; and (b) obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions. In deciding what is the object and purpose of the relevant provisions of the tax treaty, the relevant Commentary to the United Nations Model Convention will clearly be of assistance.

2.1.1 Specific legislative anti-abuse rules found in domestic law[13]

It is possible for countries to adopt in their domestic law speci c anti-abuse rules that prevent particular types of improper use of tax treaties. For example, if a country faces a problem of taxpayers moving their residence temporarily to another country in order to take advantage of the tax treaty with that country to prevent a charge to tax (for example a taxpayer moving temporarily to take advantage of the capital gains article to secure exemption on the disposal of assets), the country might enact a speci c anti-avoidance rule to prevent that treaty abuse. is rule might provide, for example, that the country can continue to tax the particular income or capital gain, notwithstanding the provisions of the tax treaty where the taxpayer moves temporarily abroad with the intention of avoiding a tax charge.

Because these speci c anti-avoidance rules prevent the enjoyment of the tax advantage that would otherwise be given by the tax treaty, they can be seen as a form of tax treaty override. However, the two countries concerned may agree that the advantage should not be enjoyed, and explicitly state in the tax treaty that treaty bene ts will not be enjoyed where the speci c anti-abuse rule applies. ese rules also raise the issue of the interrelationship between domestic anti-avoidance rules and tax treaty provisions, which is the issue dealt with in section 3 of this chapter.

2.1.2 General legislative anti-abuse rules found in domestic law[14]

Some tax systems contain a general anti-abuse rule (GAAR) in the domestic tax legislation. Again, there is a possible danger of con- ict between this general anti-abuse rule and the provisions of a tax treaty. is is addressed further in section 3 of this chapter, but the Commentary to the United Nations Model Convention[15] (and the

[13]Paragraphs 12-19 of the Commentary on Article 1 of the United Nations Model Convention.

[#&]See paragraphs 20-27 of the Commentary on Article 1 of the United Nations Model Convention.

[15]Paragraphs 21 and 22 of the Commentary on Article 1 of the United Nations Model Convention.

artistes or sportspersons who assign their income to other persons, typically a company under their control. Reference should be made to the Commentary to the specific article where the anti-abuse provision is located.

2.1.5 General anti-abuse rules found in tax treaties[19]

Aside from specific anti-abuse rules, some countries have the practice of including a general anti-abuse rule in their bilateral tax treaties. The current version of the United Nations Model Convention does not contain such a general anti-abuse rule but there are examples of the type of wording that some countries have included in paragraphs %&Ž%(aXfZW5a_ _ WfSdk a` 3df[UW# aXfZWG` [fW @Sf[a` e ? aVW Convention.[20]

Paragraph 37 of the Commentary on Article 1 of the United Nations Model Convention also contains a warning that the inclusion of such general anti-abuse rules might give the impression that, absent such a provision, other general approaches to deal with improper use of tax treaties are not possible. This is clearly a warning that countries should consider carefully before including such general anti-abuse rules in their treaties.

2.1.6 The interpretation of tax treaty provisions[21]

Provisions contained in a tax treaty are subject to interpretation, and Article 31 of the Vienna Convention on the Law of Treaties[22] provides that treaties are to be interpreted in good faith in the light of their object and purpose. There is some support for an approach that a good faith interpretation, consistent with a tax treaty's object and purpose, would lead to a conclusion inconsistent with the abuse of tax treaty

[19] BSdSYdSbZe %&Ž%) aXfZW5a_ _ WfSdk a` 3df[UW# aXfZWG` [fW Nations Model Convention.

[20] A` ^[_ [fSf[a` a` TWWf (>A4) Sdf[UWe eWWZSbfWd; ;l eWf[a` %&& BWd-sons qualifying for treaty benefits, by Joanna Wheeler.

[21] Paragraphs 38 and 39 of the Commentary on Article 1 of the United Nations Model Convention.

[22]

provisions.[23] At present, however, the support is not overwhelming, and this is an issue that should be considered very carefully before a revenue authority raises it.

2.2 Some common examples of transactions involving potential abuse of tax treaties

is part of the section considers six common examples of transactions involving potential abuse of tax treaties, and discusses the ways in which they may be countered using the various techniques described in the previous part. ese examples are not a complete list of all possibilities: some additional ones are discussed in paragraphs &'Ž++ aXfZW5a_ _ WfSdk a` 3df[UW# aXfZWG` [fW @Sf[a` e? aWW Convention. Even the examples in the Commentary are not exhaustive, and countries will no doubt encounter novel forms of improper use of tax treaties which also need to be countered by using one of the techniques described above.

2.2.1 Treaty shopping and the use of conduit companies[24]

Perhaps the most common example of tax treaty abuse is treaty shopping, where a person who is not entitled to the bene ts of a tax treaty establishes arrangements which employ other persons who are entitled to them to indirectly access the bene ts of the treaty. To take a simple example, suppose that a person who is resident in Country A derives income from a source in Country C, but there is no tax treaty between Countries A and C. However, there is a tax treaty between Country B and Country C which o ers an attractive tax advantage. e person establishes an entity — typically a "conduit company" — in Country B so that the income ows to that company, which enjoys the bene t of the tax treaty with Country C. Such arrangements will o en also rely upon the ability to extract income from Country B without paying any tax in that country or on the payment out from that country.

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[23] At present the international case law on this issue is relatively thin, the leading case being a Swiss Federal Supreme Court decision in A Holdings ApS v Federal Tax Administration (2006) 8 ITLR 536.

[24] BSdSYdSbZe &)Ž) aXfZW5a_ _ WfSdk a` 3df[UW# aXfZWG` [fW Nations Model Convention. See also chapter II, section 5, Persons qualifying for treaty bene ts, by Joanna Wheeler.

Treaty shopping is not a new phenomenon, and the use of conduit companies was discussed by the OECD in a report adopted in 1986.[25]

Various methods are suggested in the Commentary on Article 1 of the United Nations Model Convention to deal with treaty shopping, and the Commentary to the OECD Model Convention also contains further discussion of this issue.[26] One example of a speci c anti-abuse rule found in most tax treaties is the "bene cial ownership" concept in Articles 10, 11 and 12 of the United Nations Model Convention.[27] An examination of the identity of the bene cial owner of dividends or interest, for example, may be an approach that e ectively counters an attempt to abuse a treaty by treaty shopping.

2.2.2 Income shifting[28]

is topic covers a range of transactions and arrangements that are designed to achieve the result that income that would normally accrue to a taxpayer accrues instead to a related person or entity with the aim of ensuring that treaty advantages are obtained that would not otherwise be available. A simple example might be the use of a "base company", o en situated in a low-tax jurisdiction, to which tualTextFse 3(e)-21(i)

the use of Controlled Foreign Corporation (CFC) legislation, which is an example of a speci c anti-avoidance rule in domestic law.[29]

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"shadow-credit" for tax that would have been charged in the host country except for tax-incentive legislation which o ered a reduced rate or an exemption from tax for activities which are seen as encouraging economic development.[34]

ese types of tax sparing credits could give rise to a form of abusive avoidance if, for example, a taxpayer claims a shadow credit to which the taxpayer is not entitled. If a tax treaty provides for a tax sparing credit, it may be necessary for the country of residence of the investor to check carefully (using the provisions for exchange of information described below) to ensure that the shadow credit is only granted in circumstances where the taxpayer is properly entitled. is is one of several potential abuses of tax treaties where the exchange of information may be particularly valuable in assisting countries to combat tax treaty abuse.

3. The relationship between domestic anti-abuse rules and tax treaties

e second aspect of the improper use of tax treaties addressed in this chapter concerns the relationship between domestic anti-avoidance (or anti-abuse) rules and tax treaties. It is important that the operation of domestic anti-avoidance rules (whether speci c or general rules) is not rendered ine ective by the provisions of a tax treaty. An example where this has proved problematic in the past has concerned Controlled Foreign Corporation (CFC) legislation under which the pro ts received by a controlled subsidiary in a low-tax jurisdiction are attributed to the controlling parent company and taxed, either as a deemed distribution of that company or as pro ts of that company. Where the subsidiary is resident in a country which has a tax treaty with the country of residence of the parent company, it has sometimes been argued that provisions (such as the business pro ts Article) of the tax treaty prevent the operation of the CFC legislation.[35] Where

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[illegible]

As regards both these issues, tax treaties can signi cantly improve the e ectiveness of anti-avoidance rules through the provisions for mutual administrative assistance contained in the treaties.

e primary provision for mutual administrative assistance is the exchange of information provision based upon the equivalent of Article 26 of the United Nations Model Convention. Since 2011, however, the United Nations Model Convention has also contained a second provision for mutual administrative assistance in the collection of taxes in Article 27 (and the OECD Model Convention has included a similar provision since 2003). Each of these is considered below.

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Articles 1 and 2 of the Model Convention, so that it is not limited only to persons who are residents of one or both of the treaty States, nor is it limited only to the taxes covered by the tax treaty. e test for exchange of information is whether that information is "foreseeably relevant" either for carrying out the provisions of the tax treaty, or for the administration or enforcement of domestic tax laws. It is the exchange of information for the purposes of implementing domestic anti-avoidance rules that is particularly highlighted here.

Traditionally, provisions for exchange of information such as Article 26 of the United Nations Model Convention cover three forms of exchange of information. First, exchange on request where a speci c request is made by one State for information from the other. Secondly, spontaneous exchange of information where the tax authorities of one State receive information which they consider would be foreseeably relevant for the administration of taxes in the other State. irdly, automatic exchange of information where certain categories of information — payments of bank interest to account holders resident in the other State, for example — are exchanged on an automatic and regular basis. Automatic exchange of information, in particular, may identify taxpayers who have sought to avoid tax by transferring assets

of some countries that they would supply information already contained in their les, but would not go out and gather information solely

extensive arrangements for assistance in the collection of taxes in

Perhaps a nal word of warning is necessary. Treaties relieve

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