INTERNATIONAL TAXATION

DOUBLE TAX CONVENTIONS

Basics

- Double Tax treaties (DTTs) are instruments of international law
- Are usually bilateral between two (Contracting) states
- States aim, through their tax treaties to minimise the extent their residents are subjected to double taxation
- DTTs provide a consistent, common and logical basis by which the contracting state can divide the taxing rights over persons who have a tax connection with both states whether by reason of residence or by the existence of a source of income
- Where the priority to tax, even a limited right, is given to the state of source, the state of residence has the obligation to eliminate the double taxation.

DOUBLE TAXATION CONVENTION

- DTCs are (bilateral) agreements to avoid or minimise double taxation and avoid fiscal evasion with respect to taxes on income and capital.
- Also referred to as double tax agreements (DTA's), double tax treaties (DTT's) or simply tax treaties.
- are agreements signed by two countries (r.t. as contracting states) to;

i. avoid or minimise double taxation and

ii. avoid fiscal evasion with respect to taxes on income and capital.

- And thus remove barriers to cross-border trade and investment

DOUBLE TAXATION AGREEMENTS

- DTAs are a means by which the contracting states can cooperate and provide certainty by;

1. specifying tax treatment for various types of income
2. being well understood by using an internationally understood terminology and structure
3. overriding domestic law
4. being difficult to change quickly
5. Providing a procedure for the resolution of tax disputes

DOUBLE TAXATION AGREEMENTS

- Treaties all follow a similar pattern and structure as set out in the OECD or United Nations (UN) Model conventions.
- A comparison of the OECD and UN models will show that the UN model gives greater taxing rights to the source state.

OECD and UN Model Tax Convention Differences

- The main difference between the two model Conventions is that the United Nations Model Convention imposes fewer restrictions on the taxing rights of the source country.

1. Article 12 (Royalties)
2. OECD model has the definition of 'enterprise' and 'business'
3. increased taxing rights over the business income of non-residents
4. Services PE

Status of a Treaty

- A treaty is **ratified** in accordance with the domestic law of each Contracting State.
- The Vienna Convention which codifies customary international law notes in **Article 26** that: "Every treaty in force is **binding** upon the parties to it and must be performed by them in **good faith**."
- **Article 27** of the Vienna Convention also provides that "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty
- It follows that where the treaty is in conflict with the domestic law, the treaty is superior and **will override domestic law.**

Imposition of Tax

- A treaty cannot of itself impose tax liabilities where none exist under domestic law
- Tax is imposed through the charging provisions of the domestic law.
- Treaties give the right to tax
- Treaties can only reduce or eliminate domestic tax liabilities

Interpretation Rules

- Rules for interpreting treaties are derived from a number of sources;

1. **Article 31** of the **Vienna Convention** provides as follows:

"(1) A treaty shall be interpreted **in good faith** in accordance with the **ordinary meaning** to be given to the terms of the treaty in their context and in the light of its **object and purpose**."

- Treaty interpretation is purposive
- A broad interpretation of the words used in a treaty is appropriate

Interpretation Rules

2. **Article 3 (2)** of the **Model treaties** provides the interpretation rule for **undefined terms** and once again stresses the need for interpretation of such terms to be undertaken in relation to the **context** in which they are used.

- Undefined terms will be given the meaning which they have under the **domestic law of the State** applying the treaty **at the time of application** - an **ambulatory** rather than a **static interpretation** rule.

Interpretation Rules

3. The **Commentaries to the OECD and UN Model Conventions** play an important role in the interpretation of tax treaties.

- **Courts** pay attention to these Commentaries in deciding cases.
- Creating certainty for taxpayers as **consistent interpretation** by all countries

Allocation of taxing rights

- The terminology used in treaties when dealing with the allocation of taxing rights normally uses two approaches:

I. "**shall be taxable only in that State**"

- This approach gives the **exclusive right of taxation** to one of the States.

Allocation of taxing rights

II. “**may be taxed in that State**”

- This approach will indicate that the State referred to may tax the relevant income but it must be understood that it does not take away the taxing right of the other State.

Prior Right of Taxation

- Where the treaty gives the **source State** a **full or limited right of taxation**, it is the source State which has the **prior right of taxation**.
- When the **residence State** subjects that item of income to tax, it is obliged to **eliminate any double taxation**.

How income is taxed

- The various treaty **Articles which allocate taxing rights** will specify whether the income may be taxed on a **gross or net basis**.
- **Article 7 – (Business Profits)** specifies that expenses should be allowed, therefore a **net basis** of taxation.
- **Article 11 – (Interest)** allows the source State to tax **interest** paid to a non-resident limited to a percentage of the gross amount, therefore a **gross basis** of taxation.

Competent Authority

- All interaction between the two Contracting States must be carried out through the **Competent Authorities** of the two States or their **authorised representatives** as defined in **Article 3** of the treaty.
- This is especially the case with regard to **exchange of information**, **assistance in collection** and **mutual agreement procedure**.

Double Taxation Agreement Goals

- States aim to eliminate double taxation through double tax agreements to remove barriers to cross-border trade and investment by;

1. Eliminating double taxation
2. Providing certainty of tax treatment
3. Lower compliance costs
4. Lower tax rates in source state
5. Easier dispute resolution
6. Prevention of fiscal evasion

Structure of Tax Treaties

- International model tax conventions; the OECD,UN etc. follow the same basic structure that can be divided as follows:

Article	Content/ Description
1-2	Scope of the DTA: Persons and taxes covered
3-5	Definitions of specific terms utilized in the DTA: resident, permanent establishment
6-21	Taxation of income (source country taxing right)
22	Taxation of capital (source country taxing right)
23	Elimination of double taxation (residence country) - exemption or credit method
24-30	Special provisions (dispute resolution, exchange of information, fiscal privileges, assist the other state to collect taxes)
31- 32	Entry into force and termination

Structure of Tax Treaties

- Article 1 - the persons covered
- Article 2 - the taxes covered by the treaty, generally income and capital taxes
- Article 3 - general definition of the terms
- Article 4- definition of the term “resident”
- Article 5 - definition of the term “permanent establishment”

Structure of Tax Treaties

Distributive rules of the treaty (6-21)

- Article 6 — Income from immovable property;
- Article 7 — Business profits;
- Article 8 — Income from the operation of ships or aircraft in international traffic and boats in inland waterways transport;
- Article 9 — Profits of associated enterprises and transfer pricing;
- Article 10 — Dividends;
- Article 11 — Interest;
- Article 12 — Royalties;
- Article 13 — Capital gains;
- Article 14 — Income derived from professional and independent services;
- Article 15 — Income from employment;
- Article 16 — Directors' fees and remuneration of top-level managerial officials;
- Article 17 — Income derived by artistes (entertainers) and athletes;
- Article 18 — Pensions and social security payments;
- Article 19 — Income derived by government employees;
- Article 20 — Income derived by students, business trainees and apprentices;
- Article 21 — Other income; in other words, income not deal with in Articles 6-20.

Structure of Tax Treaties

- Article 23: Methods for eliminating double taxation: Article 23A (**Exemption method**) and Article 23B (**Credit method**)

Special provisions

- Article 24 provides protection against various forms of discriminatory taxation
- Article 25 provides a mutual agreement procedure (MAP)
- Article 26 deals with exchanges of information
- Article 27 assistance of collection of taxes
- Article 28 "fiscal privileges" enjoyed by diplomats and consular officials under international law.
- Article 29- Territorial extension
- Article 30 & 31 - entry into force and termination of the treaty.

Qualification for the Benefits of a Treaty

- persons who qualify for the benefits of a treaty and which taxes are covered by the treaty are covered by Articles 1, 2 and 4.
- **Article 1** - defines who is covered by the treaty, and can therefore claim the benefits of a treaty.
- **Article 2** - specifies what taxes are covered by the provisions of the treaty.
- **Article 4** - defines who can be considered a resident of a contracting state for treaty purposes.

Article 1 - Persons covered

- **Art 1** provides that the treaty will apply to **persons** who are **residents of one or both** of the Contracting States.
- "person" is defined in Article 3- general definitions
- includes **individuals** and all **legal entities**
- persons can be resident in more than one State for tax purposes.
- Thus, the term "resident of a Contracting State" is defined in **Article 4**

Taxes covered

- **Article 2 (2)** of the Model tax convention provides that the treaty will cover all taxes on income and capital or on elements of income or capital.
- Taxes on capital gains, payroll taxes and tax on capital appreciation are specifically included.
- **Paragraph 1** specifies that these taxes may be imposed by all levels of Government – central Government, political subdivisions or local authorities

Definition of resident

- **Article 4 (1)** - specifies that a **resident** of a Contracting State must be decided in accordance with the domestic law of the State applying the treaty.
- It is the **overlap of domestic tax systems** which create the possibility of **dual residence**.
- For treaty interpretation, determining which State has the sole right to claim residence is vital.
- In cases of dual residence **paragraphs 2 and 3 of Article 4** contain the tie breaker rule for **individuals** and **legal entities** respectively

Tie Breaker Rule - Individuals

- Preference is given to **permanent home** of the individual –
- personal and economic relations (**center of vital interests**) - family/social relations, occupation, place of business, etc.)
- **Habitual abode** – where he stays more frequently (look at stay in his permanent home as well as other places in the same State)
- **Nationality**
- Last resort- **Mutual agreement** by competent authorities

Tie Breaker Rule – body corporates

- **Article 4(3) OECD Model**: Where a body corporate is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its **place of effective management** is situated.

  *The place of **effective management** is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.*

Tie Breaker Rule – body corporates

- What is the place of effective management?
  - ✓ Where meetings of its board of directors usually held,
  - ✓ where the chief executive officer and other senior executives usually carry on their activities,
  - ✓ where the senior day-to-day management of the person is carried on,
  - ✓ where the person's headquarters are located,
  - ✓ which country's laws govern the legal status of the person,
  - ✓ where its accounting records are kept.
- Mutual agreement by competent authorities if the tie persists

Treaty Life Cycle

- The Key stages in the life of a double tax treaty are as follows;

1. Negotiation & Drafting
2. Signing
3. Entry into force – Article 30
4. Effective Date

QUESTIONS?