TIMING ISSUES IN THE APPLICATION OF TAX TREATIES

Seminar L

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Panel

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Case 1 – Delayed taxation

- State A negotiates a treaty with State B
- State A wants to follow Art. 7(1) of the OECD Model Tax Convention:

  "If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

- State B wants to follow the wording of the Chile-Switzerland (2011) treaty, which reads:

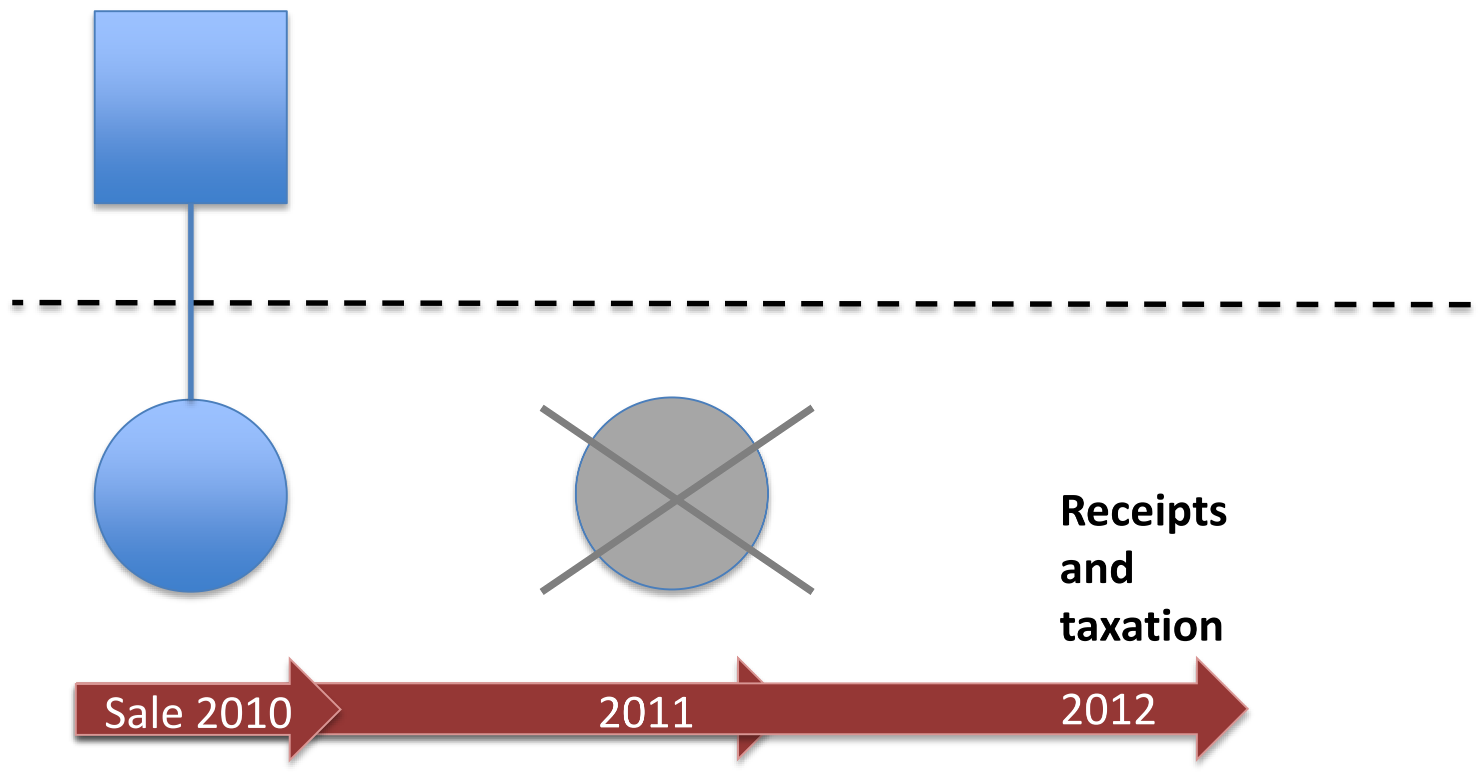
  "If the enterprise carries on ***or has carried on*** business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment. …."

Reason

- That formulation is found in many treaties, primarily in those from the United States
- The United States Treasury Technical Explanations (1984) of the United States- Canada treaty:

> “The reference to a prior permanent establishment ("or has carried on") makes clear that a Contracting State in which a permanent establishment existed has the right to tax the business profits attributable to that permanent establishment, even if there is a delay in the receipt or accrual of such profits until after the permanent establishment has been terminated.”

Case 1 – Delayed taxation



Comments on case 1

- Art. 7(1) OECD: “the enterprise carries on business” through a permanent establishment
- Timing of the recognition of income under domestic law (payment)
- Timing mismatch between treaty and domestic law
- Which one prevails?

Comments on case 1

- Art. 7 OECD applies regardless of the time at which the income is materially received
- Art. 7 OECD requires the activity to be conducted through the PE
  - Art. 17 OECD "income derived by…as an entertainer…or as a sportsperson… from that resident's personal activities"

But…

  - Art. 11 OECD "interest…paid to a resident"
  - Payment is decisive criterion in assessing when the conditions required by the treaty are satisfied

Comments on case 1

- Timing of taxation is a matter of domestic law/ Timing of taxation not regulated by tax treaty (function of a tax treaty + explicitly stated in the UN and OECD MC para 32.8 on Commentary on Art. 23 A & B)
- The US-Canada clarification provision: the US seems to have applied its domestic law view to the treaty
- The provision of the Chile-Switzerland treaty will not be relevant unless the domestic law of one of these countries defers taxation of business profits
- No idea why Chile and Switzerland would include such a provision in their tax treaty; I would be very reluctant to insert such a provision in a treaty

Comments on case 1

- Same principle for treatment of expenses incurred before or after PE: are they attributable to the PE?

- Para. 1 of Art. VII of the Canada-US treaty (1980)

- 2007 Protocol to the Canada- US Treaty

  Para. 2 of Art. VII is changed

  > 2. Subject to the provisions of paragraph 3, where a resident of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment …

2007 Protocol to the Canada-US Treaty

Para. 2 of Art. VII is changed

2. Subject to the provisions of paragraph 3, where a resident of a Contracting State carries on business, or has carried on, in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment ...

Same issue in the PE rule of Articles 10, 11 and 12:

10(4) The provisions of paragraph 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on, or has carried on, business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein ...

Hale v *The Queen*

- 1992 Federal Court of Appeal, Canada
- US resident works in Canada and receives stock-options
- Returns to the US before exercising his stock-options
- Canada taxes the employment benefit at the time of exercise of the stock-options

Art. XV

1. Subject to the provisions of Articles XVIII (Pensions and Annuities) and XIX (Government Service), salaries, wages and other remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

Employment is exercised...

- Taxpayer relies on Art. VII when arguing that Canada may only tax if employment is exercised in Canada during the year when taxation takes place

- Court sensibly rejected the argument concluding that Article VII has nothing to do with employment income

Comments on case 1

When does a tax treaty apply?

- When is the treaty in effect?
- When are the treaty's limitations felt by the Contracting States?
- Which time is taken for assessing eligibility to treaty benefits and the application of the treaty?

Comments on case 1

Alternative approach for passive income

- Partnership report principles
- Source state decides when to impose its own tax charge
- Residence state accepts that source state has applied treaty correctly

Suggested principle #1

- Tax treaties allocate taxing rights; whether, how and when these are exercised are matters of domestic law

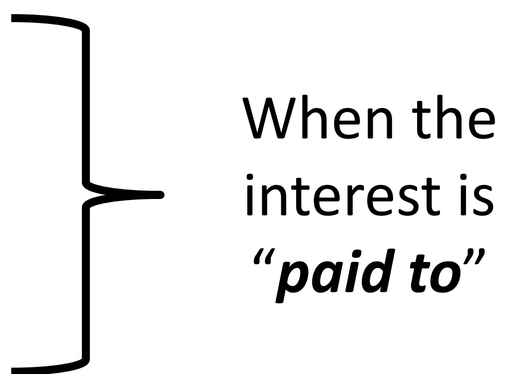
Corollary A: there is no taxation year or fiscal period in tax treaties

Suggested principle #2

- The operative words of the relevant treaty provisions implicitly govern the question of when the conditions for the application of these provisions must be satisfied

Example: Article 11

- When is it interest?
- Arising in a Contracting State when?
- The person is a resident when?
- The person is a beneficial owner when?



Case 2 – Ambulatory vs static

- State A negotiates a treaty with State B
- State A wants to follow Art. 6(2) of the OECD Model Tax Convention:

  "The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated …"

- State B wants to modify that wording as follows:

  "***As regards the application of the Convention at any time , t***he term "immovable property" shall have the meaning which it has ***at that time*** under the law of the Contracting State in which the property in question is situated …."

Reason

Paragraph 2 of Article 3:

"As regards the application of the Convention ***at any time*** by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has ***at that time*** under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

Ambulatory or static

- Two different issues:

  1) Treaty references to domestic law: date of signature or application?

  2) References to later Commentaries for purposes of interpreting a previously concluded treaty

Comments on case 2

- The change to the OECD Model was first done through Commentary clarification, then to change to Art. 3(2), following Canada's Supreme Court decision in *Melford* v *The Queen*

- Canada does not rely on that treaty change: Section 3 of the *Income Tax Conventions Interpretation Act*

Section 3 ITCIA

Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that, to the extent that a term in the convention is

(a) not defined in the convention,

(b) not fully defined in the convention, or

(*c*) to be defined by reference to the laws of Canada,

that term has, except to the extent that the context otherwise requires, the meaning it has for the purposes of the *Income Tax Act*, as amended from time to time, and not the meaning it had for the purposes of the *Income Tax Act* on the date the convention was entered into or given the force of law in Canada if, after that date, its meaning for the purposes of the *Income Tax Act* has changed

Comments on case 2

- Should the treaty negotiator of State A go for the proposal by State B? NO
- Art 3(2) is limited in its scope to terms that are not defined in the treaty, which could imply that those defined by reference to domestic law are not covered by ambulatory approach
- But Art. 3(2) is more a clarification than an exception
- Ambulatory approach for terms not defined and static approach for terms defined by reference to domestic law would be strange. What would justify that?
- Accepting State B proposal just for clarification purposes would create problems: What about other State A treaties that do not include this modified wording? What about other treaty references to domestic law (e.g. Art. 10(3) or 25(2))?

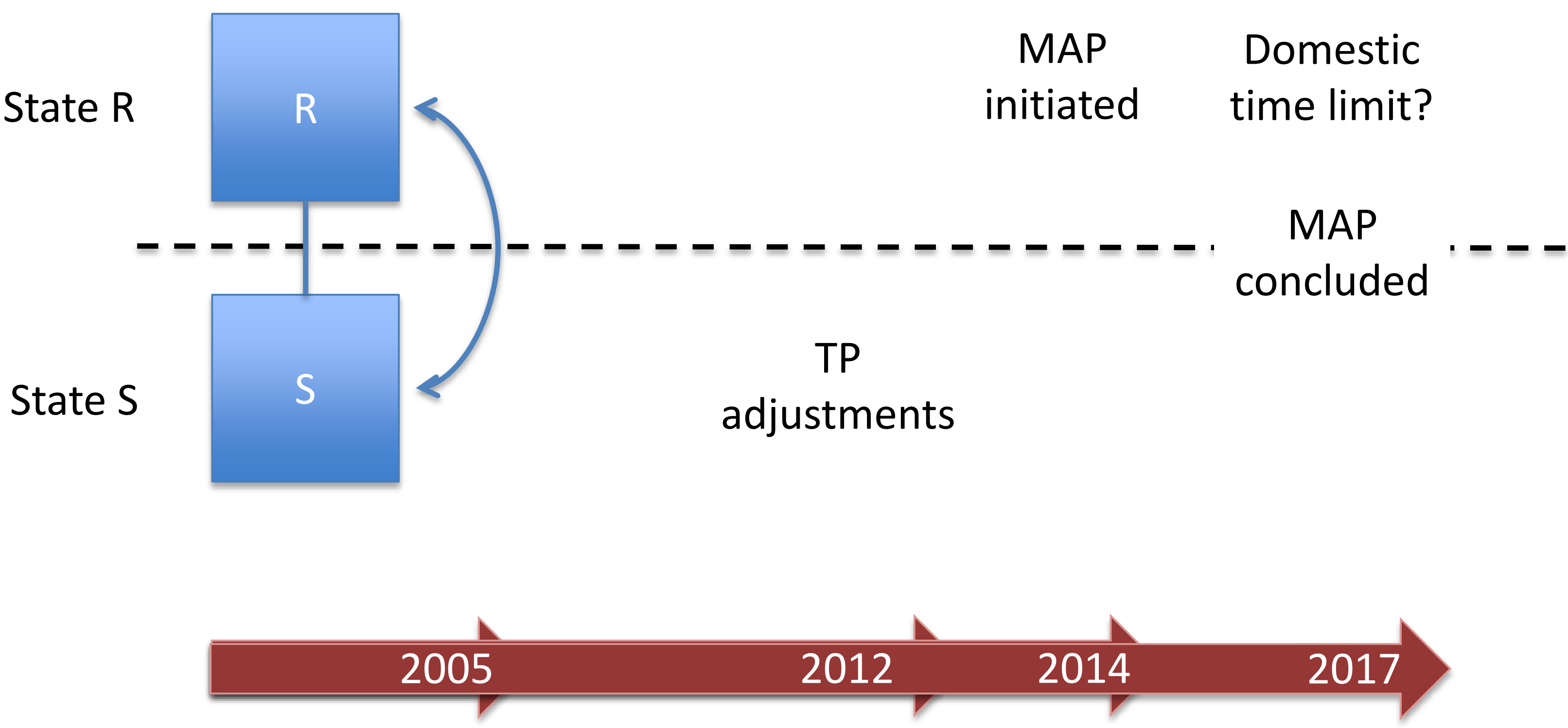
Suggested principle #3

- Unless the context indicates otherwise, any treaty reference to domestic law shall be read as a reference to the domestic law in force at the time of application of the treaty. The wording of Art. 3(2) simply confirms that principle.

Case 3 – Relief after transfer pricing adjustment

- In 2005, company R, a resident of State R, enters into transactions with its wholly-owned subsidiary S, a resident of State S.
- In 2012, after a long audit, State S makes an upward adjustment to the profits of company S in relation to these transactions. It also makes a secondary adjustment in the form of a withholding tax on the profits transferred from company S to company R.
- In 2014, company R asks State R to make a corresponding adjustment and initiates a mutual agreement procedure for that purpose.
- In 2017, the competent authorities of States R and S conclude that the initial adjustment by State S was justified but State R takes the position that its domestic time limits do not allow it to make a corresponding adjustment to year 2005 of company R.

Case 3 – Relief after transfer pricing adjustment



Time limit for relief

Para 10 Commentary on Article 9:

> "The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. … [T]his problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25)."

Comments on case 3

- Relevance of domestic time limits for treaty relief
- Relief granted following a MAP
  - Art. 25(2) OECD "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States"
  - Art. 6 EU Arbitration Convention "Any mutual agreement reached shall be implemented irrespective of any time limits prescribed by the domestic laws of the Contracting States concerned"
- What if the treaty is silent?

Comments on case 3

- Commentary on Art. 25(2), § 39

  "The purpose of the last sentence is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits"

- OECD BEPS 14, Discussion Draft, 18 December 2014

  " […] where a country does not include that sentence or deviates from its wording, it could commit to ensure that its audit practices do not unduly create the risk of late adjustments for which the taxpayers may not be able to obtain MAP relief"

Comments on case 3

- Morocco-France tax treaty does not include a provision similar to Art 9(2)
- Para 11-12 Commentary on OECD Article 25 suggests that in the absence of such a provision, MAP under Art. 25(1) could be used to solve the economic double taxation but admits two views ("Whilst there may be some difference of view, States would therefore generally regard … States which do not share this view …")

Comments on case 3

- Morocco not a member of the OECD, therefore not bound by OECD Commentary but
  - Morocco has positions on OECD Model and, unlike Brazil and India, did not disagree with para 11-12 Comm. on Art. 25
  - Para 11-12 of the OECD Model are reproduced and endorsed in para 9 Commentary on Art. 25 UN Model
- Is absence of corresponding adjustment really tantamount to "taxation not in accordance with the provisions of the Convention" if no Art. 9(2)?
- MAP under Art. 25(3) is obviously available but in the case of 25(3) MAP, treaty does not expressly override domestic time limits

Comments on case 3

- A number of countries are reluctant to have an open-ended obligation to provide a corresponding adjustment (see reservations from Chile, Greece, Hungary, Italy, Mexico, Poland, Portugal, Switzerland and the United Kingdom on paragraph 2 of Article 25

- An alternative approach is to limit the length of time during which the initial adjustment may be made: see box after paragraph 34 of the BEPS Action 14 Discussion draft (December 2014):

BEPS Action 14 Discussion draft

- "An alternative provision could also be added to the Commentary on Article 9 to limit the time during which a Contracting State may make an adjustment pursuant to paragraph 1 of Article 9. …

  … Similarly, to provide guidance to countries that wish to use treaty provisions that deal with the length of time during which a Contracting State is obliged to make an appropriate corresponding adjustment under Article 9(2), an alternative provision could be added to the Commentary on Article 9."

Suggested principle #4

- The OECD Model Tax Convention does not include a time limitation on the obligation to provide relief under Art. 7(3), Art. 9(2) or under Articles 23 A or 23 B

Case 4 – Temporal application of Article 26

- In 2005, a new treaty between State R and State S enters into force. The treaty includes Article 26 of the OECD Model Tax Convention.
- In 2006, State S requests information from State R concerning a bank account that X, a resident of State S, might have opened at a bank in State R in 2000. State S wants to know whether there is such an account and what is the balance in that account at the end of each year from 2000 to 2005.
- X, who has learned of the investigation in State S, seeks a court order in State R to prevent any information related to events that occurred before the entry into force of the treaty (including the opening of the bank account in 2000) from being exchanged by State R.

Entry into force provision

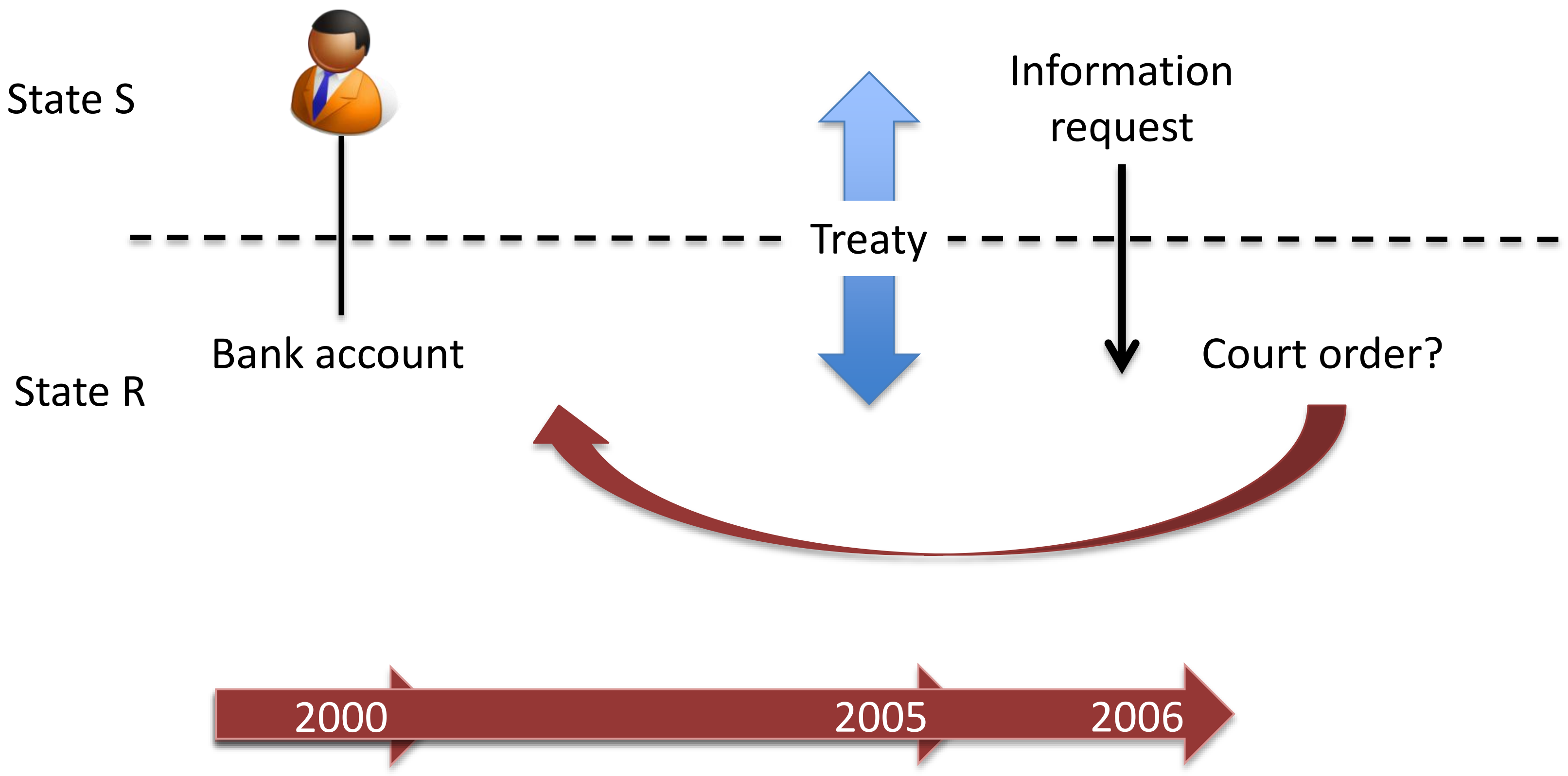
Article 30 of the treaty between States R and S:

"The provisions of the treaty shall have effect:

a) in respect of taxes withheld at source on amounts paid or credited on or after the first day of January of the calendar year next following the year of the entry into force of the Convention;

b) in respect of other taxes for taxation years beginning on or after the first day of January of the calendar year next following the year of the entry into force of the Convention."

Case 4 – Temporal application of Article 26



Comments on case 4

- Swiss case on exchange of information

- 2002 decision of the Swiss Federal Court of appeal (*Case BGE 2A.551/2001*):

  - Information requested by the IRS in respect of bank accounts in the name of individuals X and F for taxation years 1990 to 1997.

  - The 1996 tax treaty entered into force in 1997 and applied to taxes for the periods after 1 January 1998

  - Is article 26 of the 1996 treaty applicable? The Court said YES!

Comments on case 4

- Decision of the Court:
  - taxes for the years 1990-1997: out of the scope of the treaty
  - however, the entry-into-force article only covers the provisions of the treaty **other than** procedural provision
  - the exchange of information – being a procedural provision – applied both immediately and <u>retroactively</u> after entry into force.

Comments on case 4

- Hypothetical case: 2008 Italian profits of an Italian subsidiary of US parent adjusted in 2015
- Subsequent treaties:
  - (1984) Italy-US Treaty (effective as from 1 January 1985) → Old treaty
  - (1999) Italy-US treaty (effective as from 1 January 2010) → New treaty
- Opening of a MAP in 2015, which treaty applies?

Comments on case 4

Art. 28(4) New Treaty:

"The provisions of the prior Convention shall cease to have effect when corresponding provisions of this Convention take effect in accordance with paragraphs 2 and 3 [*i.e., 1 January 2010*] , and the prior Convention shall terminate on the last date on which it has effect in accordance with the foregoing provisions of this paragraph."

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Comments on case 4

US Technical explanation (New Treaty)

"A case may be raised by a taxpayer under a treaty with respect to a year for which a treaty was in force after the treaty has been terminated. [...] A case also may be brought to a competent authority under a treaty that is in force, but with respect to a year prior to the entry into force of the treaty. The scope of the competent authorities to address such a case is not constrained by the fact that the treaty was not in force when the transactions at issue occurred, and the competent authorities have available to them the full range of remedies afforded under this Article. **Even though the prior Convention was in effect during the years in which the transaction at issue occurred, the mutual agreement procedures of the Convention would apply**. "

Comments on case 4

US Technical explanation (New Treaty)

- Final outcome: different treaties apply at the same time

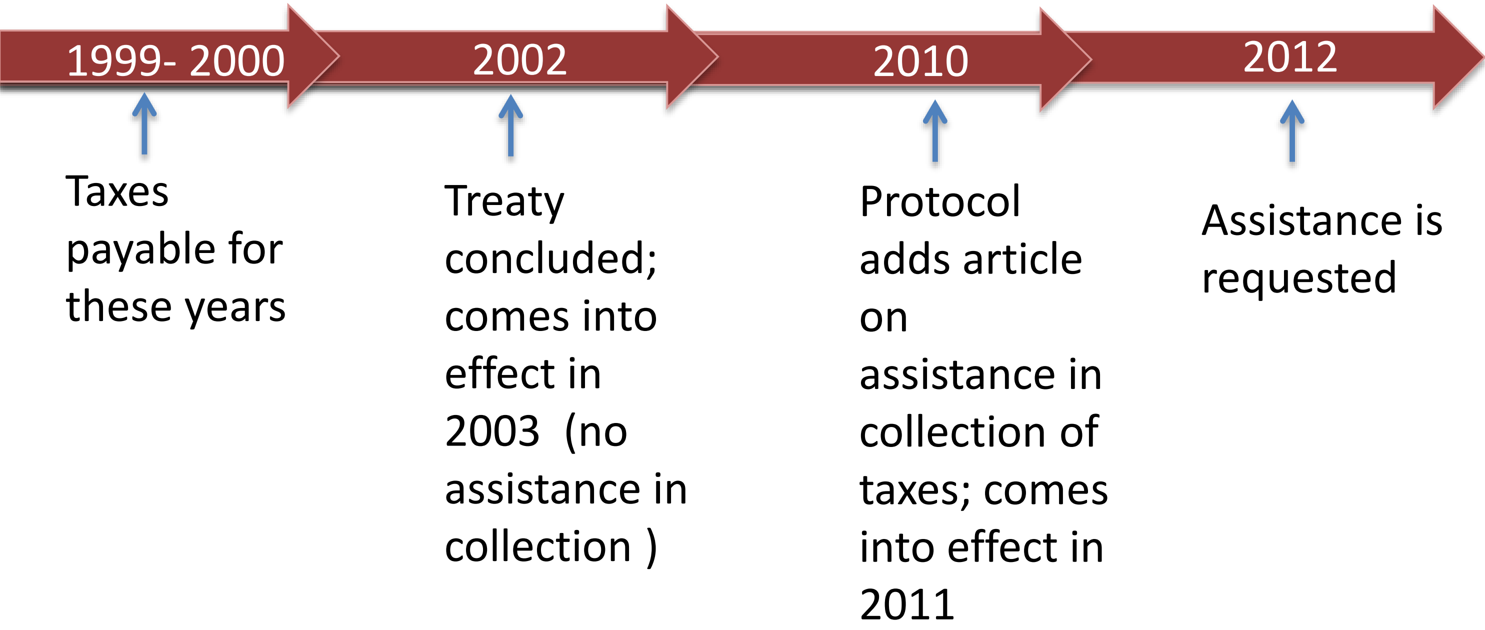
Comments on case 4

- 2013 decision of the Court of Appeal of England and Wales (Civil Division) in *Ben Nevis (Holdings):*
  - Taxes owed by Ben Nevis Holdings for taxation years 1999 and 2000; final determination in 2010 (tax, interest and penalties) of ZAR 2.6 billion
  - Did not pay; transfer assets of Ben Nevis to a holding with a bank account in UK
  - SARS asks HMRC for assistance in collection in 2012

Ben Nevis (Holdings)

- Treaty signed in 2002 did not have assistance in collection provisions; Article 27 provided that the treaty would enter into force on the date of the receipt of the later of the notifications and its provisions would have affect "in South Africa … with regard to other taxes, in respect of taxable years beginning on or after 1st January next following the date upon which this Convention enters into force"
- Art. 4 of the 2010 Protocol adds an article on assistance in collection of taxes to the treaty; Article VI(c) of the Protocol provided that the new Article would have effect "in respect of requests for assistance made on or after the date of entry into force of the protocol".

Ben Nevis (Holdings)



Ben Nevis (Holdings)

- SARS and HMRC prevailed in both the High Court and the Court of Appeal

- Court of Appeal held that the Protocol contained its own effective dates (in respect of requests for assistance made on or after the date of entry into force of the protocol) and that it was difficult to see why one should take account of the effective dates of the 2002 treaty (taxpayer had argued that effective date of Protocol was incomplete as it did not specify with respect to which taxes).

Mario's hypothetical case

- If the same MAP, does not matter: States should not try to deny MAP on such technicality
- Art. 28(4) suggests old treaty applies
- US TE is unilateral view; except for last sentence, it is cut-and-paste from TE on 1996 US Model
- Art. 28 VCLT: "Unless a different intention appears from the treaty or is otherwise established, its provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party."

Commentary on Art. 28 VCLT

- Refers to the International Court of Justice decision in the *Ambatielos* case (*I.C.J. Reports 1952,* p. 40) where court rejected Greek Government's argument that "under a treaty of 1926 it was entitled to present a claim based on acts which had taken place in 1922 and 1923."
- Discussion of other precedents
- Conclusion "…when a jurisdictional clause is attached to the substantive clauses of a treaty as a means of securing their due application, the non-retroactivity principle may operate to limit *ratione temporis* the application of the jurisdictional clause."

Comments on case 4

OECD Model

- Art. 30 determines which tax charges are covered
- Procedural provisions follow
- Art. 26 applies to “foreseeably relevant” information
- Question about taxes not covered by Art. 2

Non-OECD provisions may have different rules

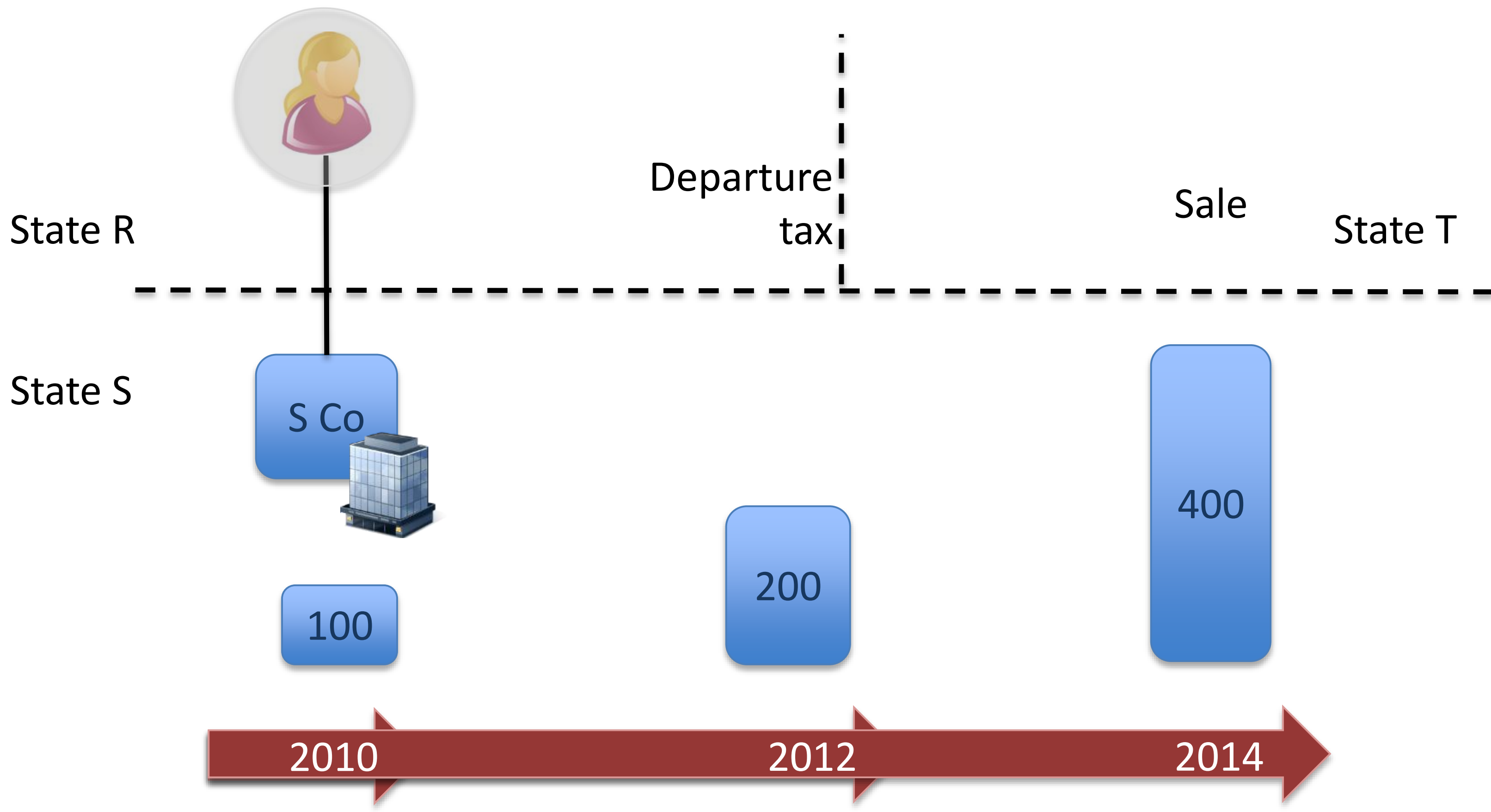
Suggested principle #5

- Unless the treaty or a protocol provides otherwise, the procedural provisions of Articles 25, 26 and 27 are governed by the rules of the treaty concerning the temporal application of the treaty in relation to the taxes covered by that treaty.

Case 5 – Change of residence

- In 2010, X, a resident of State R, acquires all the shares of SCO, whose only asset is immovable property situated in State S. X pays 100 for these shares.
- In 2012, X becomes a resident of State T. As a result of the departure tax provisions included in the tax law of State R, X is deemed to have alienated her shares of SCO "immediately before ceasing to be a resident" (the shares are valued at 200 at that time).
- In 2014, X sells her shares of SCO for 400.

Case 5 – Change of residence



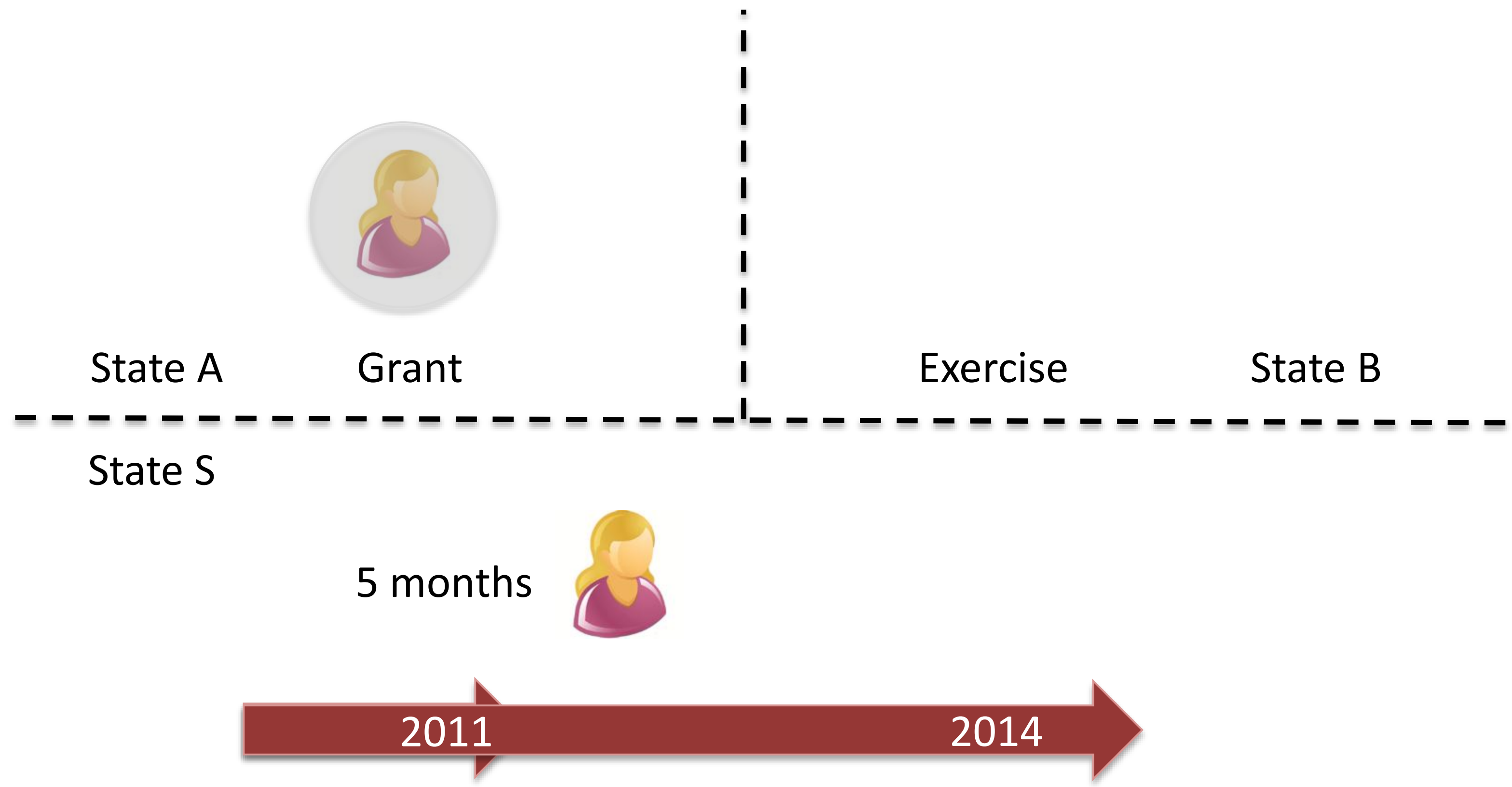
Issues

- Does the treaty between State R-State T prevent State R from applying its tax in 2012?
- Which State may tax the gain in 2014? On what gain?
- How is double taxation eliminated in 2014?

The stock-option example in paragraph 4.1 of the Comm. on Art. 23

- X is a resident of State A in 2011, when an employee stock-option is granted to her. State A taxes the employment benefit from stock-options when the option is granted.
- During the period of employment covered by the stock-option (the vesting period), X works 5 months in State S.
- In 2014, X becomes a resident of State B and exercises her stock-option. State B taxes the benefit at the time of its subsequent exercise.

The stock-option example in paragraph 4.3 of the Comm. on Art. 23



Paragraph 4.3 of the Comm. on Art. 23

- "Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation. The mutual agreement procedure could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State"

Comments on case 5

Capital gains:

- Inherent time issue
- No time apportionment in OECD Model
- Increasingly in concluded treaties – solutions for overlaps

Comments on case 5

- Would it make a difference if tax is collected at a later time upon realization of the capital gain?
    - No, tax collection is a matter of domestic law.

- Trailing taxes

Comments on case 5

- Both States have to provide relief for the tax levied by State S; issue is relief of double taxation between State R and State T
- Departure tax is another example of residence-residence double taxation not dealt with by tax treaties because residence is different at different times
- A modified version of the stock-option solution could be appropriate: each State should provide relief as regards the residence-based capital gains tax that was levied by the other State on the part of the gain that accrued during the period of residence

Observation

- The OECD Model Tax Convention does not provide for the relief of dual residence taxation where residence taxation takes place at different times and none of the two States can be considered to have levied source taxation

- Should the OECD Model be changed to address that issue? If yes, what should be the rule?