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The notion of tax and the elimination of international double taxation or double non taxation

IFA Subject 2

27 September 2016

Members of Panel



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- W. Cui, U. British Columbia (art. 2 GTTC IBFD)
- J. Hey, U. Cologne
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- R. García, Secretary, IBFD



Introduction



Double taxation / Concept of Tax: Introduction to OECD MC 2014

- 1. International **juridical double taxation** can be generally defined as the **imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter** and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the **importance of removing the obstacles that double taxation presents to the development of economic relations between countries.**
- . . .
- 3. This is the **main purpose of the OECD Model Tax Convention on Income and on Capital . . .**

Double Taxation and the Concept of Tax

- Elimination of double taxation:
 - Justified to promote free trade
 - Requires to compare taxes of two States (flexibility)
- From the 1920s we assumed different ‘silos’ for purposes of ‘comparison’:
 - Income / capital, Consumption, inheritance and gift, social security
- But . . .
 - Do we know the boundaries of the ‘silos’ and what can be put inside?
 - Do we even know the scope of the concept of tax?



Goal of Seminar: Exploring Consequences of What We Have

- Tax landscape very diverse today:
 - Taxes do not fall squarely in silos: hybrid taxes
 - All kinds of different taxes for different reasons, with different forms / names
- No clear contours of silos:
 - Tax policymakers do not always pay attention to treaties and their categories
 - Dodging treaty obligations
 - Attempts to make taxes creditable in other countries

Conflicts? Fragile International Relations

- More double taxation and less double non-taxation than appears?
- Practical problems:
 - Source country, access to treaties, residence country (exemption and credits) etc.
 - Affects broad range of taxpayers: MNEs and SMEs, individuals, banks, wealth management, funds and investment vehicles, extractive industries, etc.
- BEPS now part of the landscape
 - Some of hottest topics connected with the concept of tax on income



Structure

- General Report + domestic provisions to eliminate double taxation
- Part 1:
 - Art. 2 and different versions (main problems)
- Part. 2:
 - Concept of tax / tax on income / capital (in connection with other silos)
- Part. 3:
 - Concept of tax and art. 4, 23 OECD / UN MC
- Part. 4:
 - BEPS and concept of tax on income
- Not dealt with:
 - Art. 24, 26 and 27 OECD MC/TIEAs/Mutual Assistance Convention (Council of Europe/OECD)
 - EU tax Law



The General Report and the Branch Reports (MH)



The Topic of the General Report

Notion of tax in relation to the elimination of double taxation and double non-taxation

- Broad approach: juridical, economic, factual double taxation or double non-taxation
- Tax treaties eliminate only within their scope
 - What are the taxes covered by tax treaties?
 - What are not?
- What taxes are covered by the unilateral rules against double taxation or double non-taxation?



The General Report and the National Reports

- Three main parts:
 1. The distributive tax treaty articles – Article 2 notion of tax
 2. Elimination of double taxation – exemption and credit
 3. Elimination of double non-taxation – provisions against
- 43 branch reports + EU report



Fundamental Issue: Comparability of Taxes

- When are taxes sufficiently **comparable** and levied on **the same subject matter** that double taxation exists and should be eliminated?
 - E.g. distinction between tax on income and tax on capital
 - Relevant both in the elimination of double taxation and double non-taxation
 - explicitly or implicitly required
- **Conclusion: comparability is crucial but difficult to determine**
 - Double or double-non taxation



Diversity in Concepts, Policies and Interpretation

- **No universal definition of "tax on income" or "tax on capital"**
 - Relevance of tax subject, tax object, tax base, purpose of a tax or the name of the tax?
 - Hybrid taxes that do not fit in the categories
 - ⇒ Double taxation? double non-taxation?
- **Variations on how art. 2 is drafted are highly relevant**
 - Only general definition, no list of taxes covered
 - No general definition, only an exhaustive list of taxes covered
 - List of taxes exhaustive or illustrative ("in particular")
- **Diversity in interpretation**
 - Tax is an undefined treaty term: domestic law meanings vs. contextual meanings?
 - Form vs. substance?
 - Taxpayer friendly interpretation or strict approach?



Domestic Provisions to Eliminate Double Taxation (PB)

Foreign Tax Credit in Domestic Law

- Jurisdictions that choose to eliminate double taxation through a foreign tax credit put greater emphasis on capital export neutrality
 - Do not intend to create an incentive for their residents to invest abroad
 - Therefore, the tax burden should be the same whether investing in residence jurisdiction or another jurisdiction
- It is axiomatic that the domestic law must have a concept of “tax”
- Moreover, to ensure neutrality, foreign tax credits should be determined separately for each type of tax



Limiting Credits to Similar Taxes May Result in Double Taxation

- An alternative minimum tax based on net assets may result in loss of foreign tax credit
 - Mexico made its assets tax an “add-on” to the income tax (instead of an alternative to the income tax) to ensure United States would give a credit
- Expanded social security taxes may pose difficulties
 - Since 2013, United States imposes a tax on “net investment income tax” to help fund Medicare
 - ✓ Example: U.S. citizen resident in Germany sells property. Total German tax exceeds U.S. tax on sale. Can excess German tax offset the NIIT? United States says “no”.
 - Australia may reach opposite result because Medicare levy deemed to be an income tax, so foreign tax may be credited against Medicare levy



Ensuring that There is no Disincentive to Foreign Investment

- Rules that appear strict in law or regulation may be interpreted more generously by the courts because of perceived risk of double taxation
 - Exxon case concluded that UK petroleum revenue tax was creditable under U.S. domestic law, so treaty basketing rules did not apply
 - PPL case resulted in credit for UK “windfall tax” even though couched in terms of increase in value of privatized companies
- Some countries, such as the United Kingdom and Japan, will give credit for state, provincial, or local taxes under domestic law



Concept of Tax under Domestic Exemption Systems

- A jurisdiction that chooses to eliminate double taxation through an exemption system is more concerned about capital import neutrality, ensuring that its residents can compete in foreign jurisdictions
- It is not *necessary* for an exemption jurisdiction to develop a concept of tax, because it can simply exempt *income* earned outside that jurisdiction
- Nevertheless, some do so because of concerns about double non-taxation
- For example, Belgium applies its unilateral exemption only to foreign income that is “taxed” abroad
 - Sidro case concludes that the income need only be subject to “normal” income tax regime, whatever form it takes and even if it excludes some items that would be taxable in Belgium
 - Spain also uses the concept of comparable taxes in the exemption method (AMJ)



Tax Treaties Do Much That Domestic Law Cannot

- Domestic law is too blunt to produce the correct result in many cases
 - In the case of credit countries, domestic law frequently will not relieve double taxation
 - In the case of exemption countries, issue is the creation of double non-taxation
- Treaties also limit source country taxation
 - Ideally, restrictions on source country taxation apply when there is a risk of double taxation
- Tax treaties can be more finely tailored to mesh the systems of the two jurisdictions
 - Can provide source rules, timing, etc. in order to ensure foreign tax credit is not lost



Part I

Tax Policy Issues on Article 2 OECD MC



Article 2 OECD MC

1.This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2.There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3.The existing taxes to which the Convention shall apply are in particular:

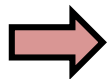
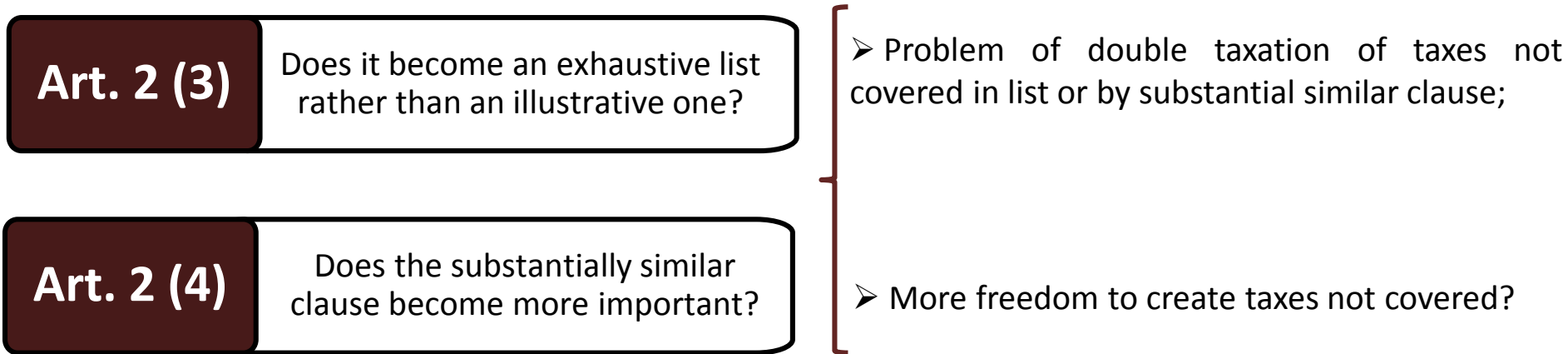
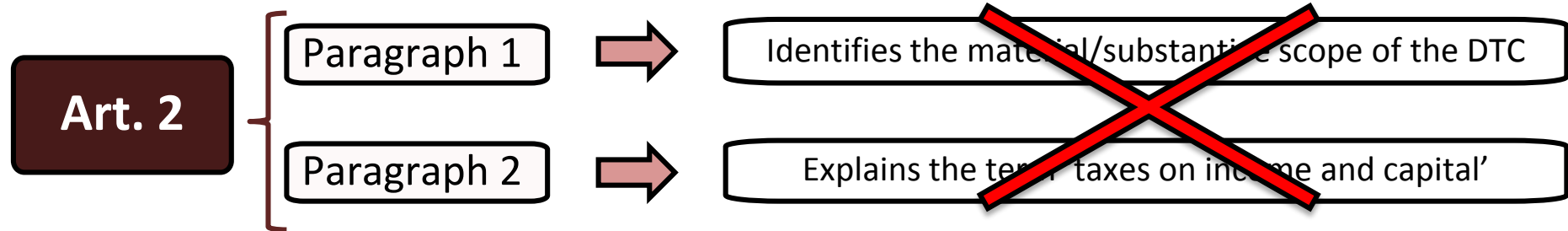
- a) (in State A):
- b) (in State B):

4.The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.



Policy of not Including Art. 2 (1) and (2) (LES)

Consequences of the Exclusion of Art. 2(1) and (2)



Several countries: Japan (1967); France (1971); Denmark (1974); Austria (1975); Sweden (1975); Luxembourg (1978); Argentina (1980); Norway (1980); Hungary (1986); India (1988); Korea (Rep.) (1989); China (1991); Finland (1996); Portugal (2000); Israel (2001); Venezuela (2005); Trinidad and Tobago (2008); Turkey (2010);



Limited Versions of Art. 2(1) and (2): Consequences and Asymmetries

Art. 2 (1)

~~“or of its political subdivisions or local authorities”~~

Residual double taxation



USA DTCs

- **Reservation** on Art. 2(1) of the OECD-MC regarding local taxes
- **US Model**

USA

Local taxes **not** included

Switzerland

Local taxes included

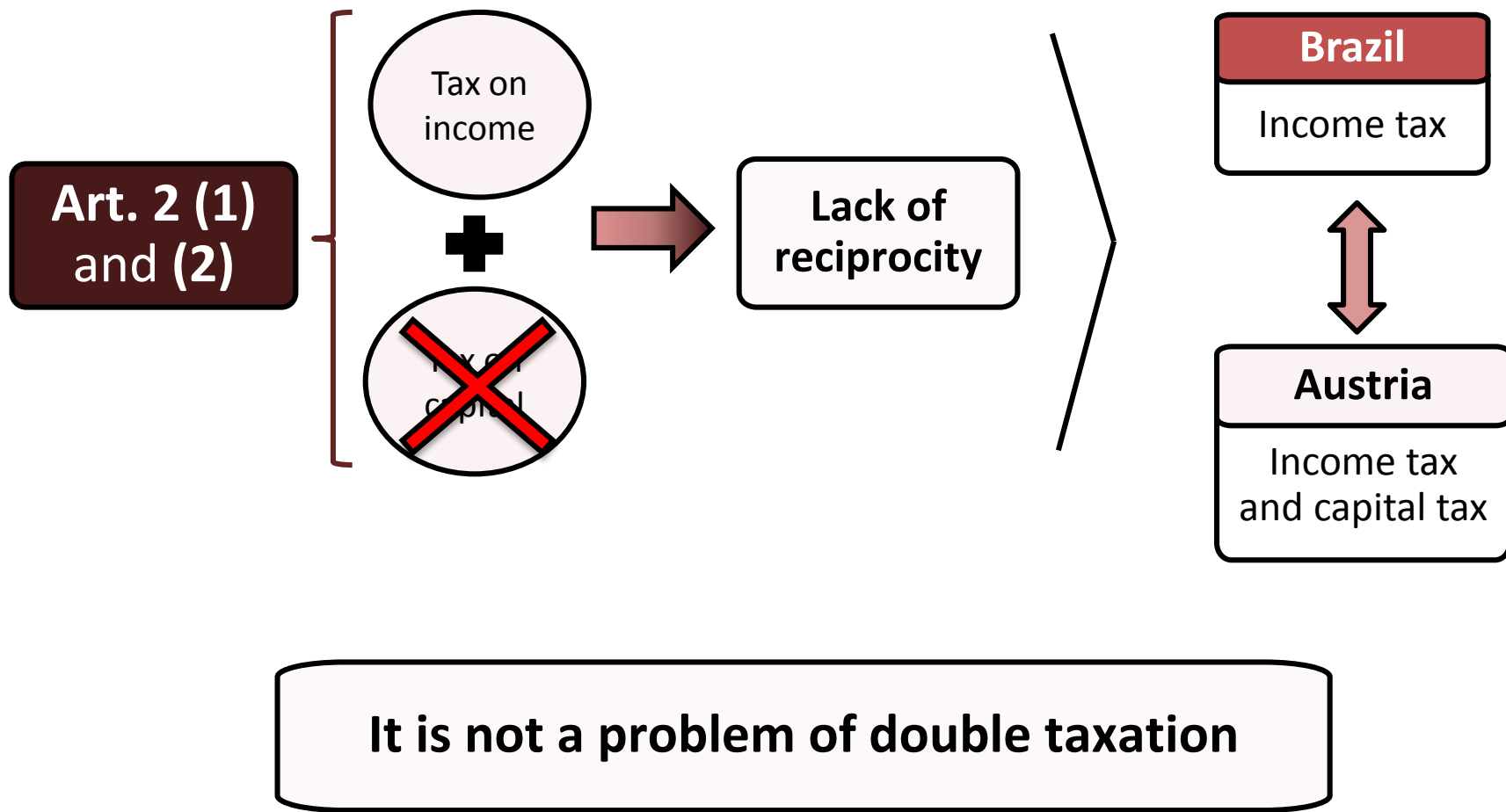


Asymmetric Treaties

Example US (PB)



Limited Versions of Art. 2(1) and (2): Consequences and Asymmetries

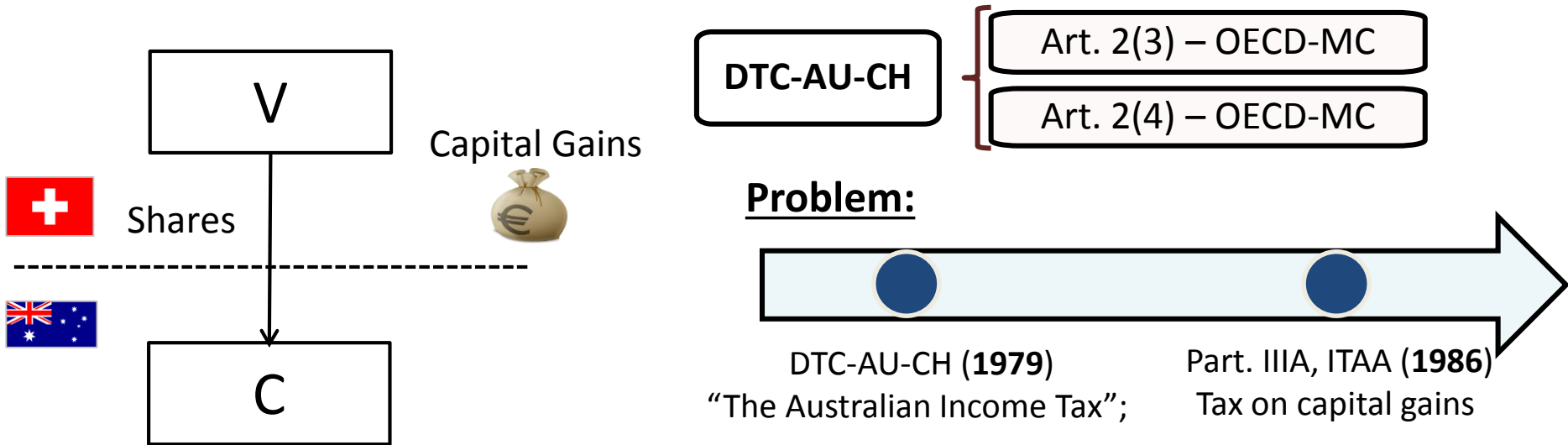


Consequences of the Exclusion of Art. 2(1) and (2)



Australia Case Law

Federal Court, *Virgin Holdings SA vs. Federal Commissioner of Taxation*, FCA 1503, 2008.



Judge Edmond J.

“The Australian income tax” in Art 2(1)(a) accommodated and encompassed, at the time of the conclusion of the Swiss Agreement, the taxation of capital gains”

“I have great difficulty in comprehending why the tax on the capital gain is not substantially similar, if not identical, to the” Australian income tax



Relevance of Paragraphs 1 and 2 of Article 2 (PB)

Arguments for Article 2(1) and 2(2)

- Like Brazil, the United States for many years did not include Article 2(1) and 2(2) in its tax treaties
 - Probably motivated by concern about providing a tax credit for something other than net income taxes
- Experiences, both positive and negative, cast doubt on this policy
 - In late 1990's, Mexico proposed imposing a withholding tax on cross-border insurance premiums, but Article 2(2) would have made it a covered tax, preventing imposition on U.S. insurance companies
 - When Netherlands introduced system imputing fixed return of 4% on investment income, lack of Article 2(1) and 2(2) raised question of whether tax would be creditable – had to conclude that the tax was “substantially similar” to old system



Role of Article 2(3)

- Is list of taxes in Article 2(3) exhaustive or exemplary?
 - As demonstrated, if Article 2(1) and 2(2) are not in treaty text, then list must be exhaustive
 - If Article 2(1) and 2(2) are included in treaty text, then list is intended to be illustrative (see Paragraph 6 of Commentary), although this may be less clear if “in particular” is left out of introduction
- Article 2(3) may expand scope of treaty if it lists taxes that would not be covered by Article 2(2)
 - Purpose most likely is to limit source country taxing rights
 - May also intend to require residence country to provide credit for a non-creditable tax



Scope and Importance of Article 2(4)

- Article 2(4) is intended to ensure that treaty continues to apply to relevant taxes introduced after date of signature of the treaty
- If treaty includes Article 2(1) and 2(2), then Article 2(4) will be superfluous with respect to anything that falls within generic definition
- Article 2(4) may not be important at all if Article 2(3) refers simply to a Contracting State's Income Tax Act
- Article 2(4) becomes more important if:
 - Article 2(1) and 2(2) are not included, because treaty coverage otherwise is not ambulatory with respect to taxes
 - Article 2(1) and 2(2) are included in treaty, but Article 2(3) extends treaty coverage to taxes other than those described in Article 2(2)



Part II

The Concept of tax on Income and Capital in Article 2 OECD MC



The Concept of Tax (WC)



The General Concept of “Tax”

- What is a “tax”?
 - No definition in the OECD Model (nor, for that matter, under the domestic laws of many countries)
 - The answer must not just be a matter of labels
 - However, is there a universal meaning of “the” term?
- Labels can be misleading, reflecting domestic law distinctions that should not matter for treaty purposes:
 - “Tributo”, “impostos”, “contributions”, “tariffs” ...; what must be approved by Parliament and what may be enacted by acts of government, ministers, etc
 - Narrow readings of “tax” in the treaty context have generally been criticized by treaty specialists



The General Concept of “Tax”

- However, there has been little Article 2-based legal authority directly about the meaning of “tax”
- Comparative studies of domestic laws have tended to identify the following essential features of a tax:
 - Taxes are “mandatory”, “compulsory” or “involuntary” levies, enforced by law, and distinct from “voluntary” payments
 - Taxes are imposed by an organ of government; and
 - Taxes are paid without anything received specifically in return for the payment



The General Concept of “Tax”

- Other features seem essential to some but not to others: e.g. exclusion of sanctions; paid for public purposes, to promote the general interest; the absence of earmarking...
- In many countries, there are trends to meet budgetary needs not with traditional taxes, but with earmarked levies and user fees. In other words, “non-tax” revenue is likely to grow (as a percentage of budgets) for domestic political and policy reasons. The growing significance of such levies has bearings on cross-border transactions as well



Concept of tax: Specific Cases (1) (JH)

Concept of Tax: Specific Cases

Earmarked taxes

- Earmarking which does not result in individual benefits does not undermine the nature of a levy as a tax.

EXAMPLES:

- Indian “Education Cess,” levied as a percentage of income with the purpose to fund the improvement of public education in India = tax on income (Income Tax Appellate Tribunal Kolkata [2012])
- Irish “Universal Social Charge” = tax, no individual benefits

Concept of Tax: Specific Cases

Special levies

- Very similar to taxes
- Main difference:
 - Not levied for general public purpose, not part of the general budget, but revenue flows into special funds
 - Levied only from certain groups/industries
- Way to circumvent classification as tax, often for domestic constitutional restrictions of the power of taxation

EXAMPLES:

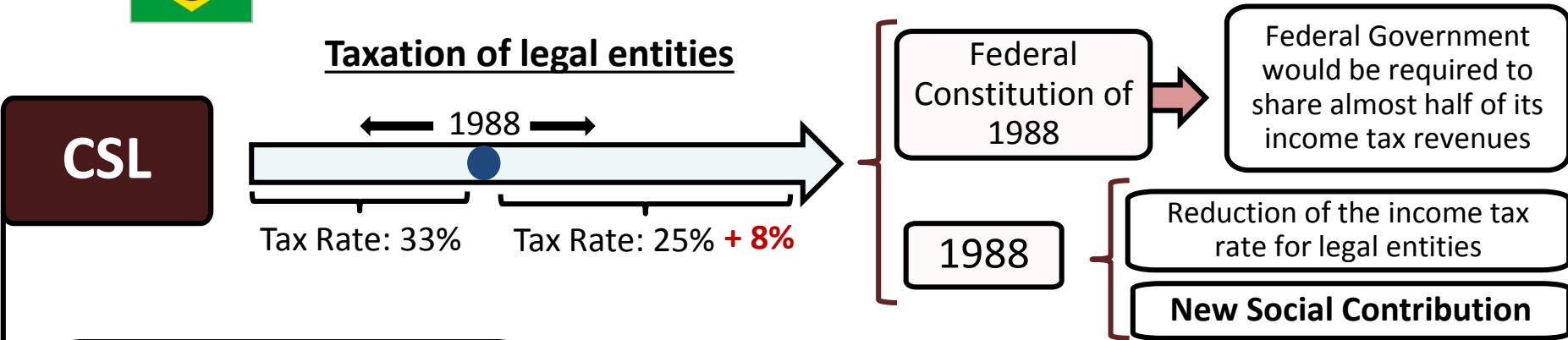
- European Bank Levies, Financial Crisis Responsibility Fees
→ basis can be profit, assets, deposits, etc.
- Brazilian “contributions”



Concept of Tax:

Brazilian Social Contribution (2) (LES)

Brazilian social contributions



Is it tax?

It has substantially the **same tax base** as the income tax and the **same taxpayers**.

The difference remains on the destination and due to this difference, different constitutional regime applies

Is the CSL included by Art. 2?

Pre-1988 treaties

Huge Debate

5 cases ✓

2 cases ✗

Post-1988 treaties

4 treaties



Several not

Law 13,202/2015

- "Interpretative rule";
- Even for the others eleven treaties after 1988?



Concept of Tax: Specific Cases (3) (JH)

Concept of Tax: Specific Cases

Imposition “on behalf of a contracting state/political subdivisions/local authorities”

- Wording: only territorial subdivisions?
- Levies on behalf of religious bodies, supranational/international organizations are not covered, except when explicitly included
EXAMPLES: Treaties Canada-Kuwait, Spain-Kuwait for the Islamic contribution “Zakat;” most treaties concluded by Denmark, Finland, and Sweden as regards their church taxes

The term “on behalf of a contracting state” cannot be interpreted as “on behalf of any public purpose/public good”

EXAMPLE: German Church Tax (levied as a percentage of the income tax liability)

- German position: Mere administration by public tax authorities is not sufficient
- However, Canadian decision *Kempe vs. The Queen*, [2001] 1 CTC 2060 (TCC)

Concept of Tax: Specific Cases

Charges accessory to taxes, like increases, costs, interest, and penalties

- Depends on whether they are considered part of the “principal duty,” directly and inextricable connected with the tax liability
 - Interest: Calculation depends on the amount of tax liability → should be covered

EXAMPLE:

German 6% tax interest has the character of an extra tax

- Penalties: If not dependent on the tax liability (e.g., for the violation of documentation requirements), not directly linked → not covered



The General Concept of Tax (conclusion 1) (WC)



The General Concept of “Tax”

- Assuming that the magnitude of “non-tax” levies is non-negligible, how should double tax treaties take them into account—how should countries coordinate in respect of them?
 - Allowing crediting of source country’s traditionally “non-tax” levies against residence country’s traditional taxes?
 - No credit but only deductions in the residence country? (This would normally be provided under domestic law instead of treaty law)

The General Concept of “Tax”

- The proper scope of the term “tax” in the treaty context thus seems fundamentally to be a normative, not positive legal, question
- As a positive matter, the scope of the term “tax” simply reflects the varying approaches and intentions of contracting states regarding treaty negotiation
- Take the issue of whether social security charges are “taxes”.
 - The OECD Commentary answers in the negative (there being “a direct connection between the levy and the individual benefits to be received”)
 - But countries may well include social security, mandatory health insurance, etc. in their double tax conventions



Concept of Tax: Narrow v. Broad (Conclusion 2)(AMJ)

Concept of Tax: Narrow v. Broad

- Concept of tax 'Entry gate to article 2 (1)
- Two possibilities: narrow v. broad interpretation
- Different outcomes
- Problem in broad interpretation:
 - Can payment to semi-public, private bodies with public competences or other compulsory payments be included?



Concept of Tax: Social Security Contribution (PB)



Concept of tax and Social Security Contributions

- In principle, social security taxes should be encompassed within Article 2(2) definition as “taxes imposed...on elements of income” or “on the total amount of wages or salaries”
- Some countries, such as the United States, explicitly exclude social security taxes from Article 2(2)
- Some treaties specifically include social security taxes as covered taxes to avoid double taxation (e.g., U.S.-Canada treaty)
- Paragraph 3 of the Commentary on Article 2 states that Article 2(2) does not apply to charges “where there is a direct connection between the levy and the individual benefits to be received”
 - Refers specifically to social security charges
 - Sweden, for example, has concluded that the French social security contribution is not an income tax and therefore will not give a credit for it under the tax treaty



Concept of tax: Relationship between Contributions and Benefits

- However, extent of the link between contributions and benefits depends on the particular system and tends to change over time, eroding argument that all payments that a State considers to be a “social security charge” should be excluded from treaty coverage
 - United Kingdom has even studied possibility of combining national insurance contributions and income tax
 - In France, courts have determined that the mere fact that a charge is used to fund social security does not qualify it as a social security charge
 - What about U.S. “net investment income tax”, a Medicare surtax not imposed on employment income?



Tax Treaty or Totalization Agreement?

- Purpose of social security totalization agreements is to coordinate systems, including to prevent mobile workers from making contributions to States from which they are unlikely to qualify for benefits
- Accordingly, they may provide more generous source-State exemptions, so that a taxpayer will be better off under a totalization agreement (if there is one) than a tax treaty
- If there is a question about whether a new tax is a social security tax covered by a totalization agreement, or an income tax, tendency is to default to the totalization agreement



Concept of Income Tax (JH)

Concept of Tax on Income

Tax on income: What is income?

- No DTC definition of the term “income” → autonomous interpretation?
- Name + technique is not decisive, material concept of income
 - Mainly Schanz-Haig-Simons concept
 - taxable event/tax base
 - gross vs. net income, fictional income
 - consumption type vs. capital type income
 - In general: **wide understanding** necessary

EXAMPLES:

- Dutch Box 3: tax base = fictitious income as percentage of the capital value
- German tonnage taxation: tax base = profits from shipping measured by the tonnage
- Austrian municipal tax: tax base = total amount of salaries and wages paid by an enterprise to its employees
- Hungarian tax on advertising activities: tax base = adjusted revenue from advertising
- Indian equalization levy



Concept of Tax on Income

Relevance of the tax subject? *Whose income?*

- Art. 2 (1) leaves characterization open: “taxes ... irrespective of the manner in which they are levied.”
- Tax burden can be transferred by legal definition to a different person

EXAMPLE: Indian Dividend Distribution Tax is designed as a tax of the distributing company instead of a withholding of the tax of the shareholder

Is it an income tax of the company or of the shareholder?

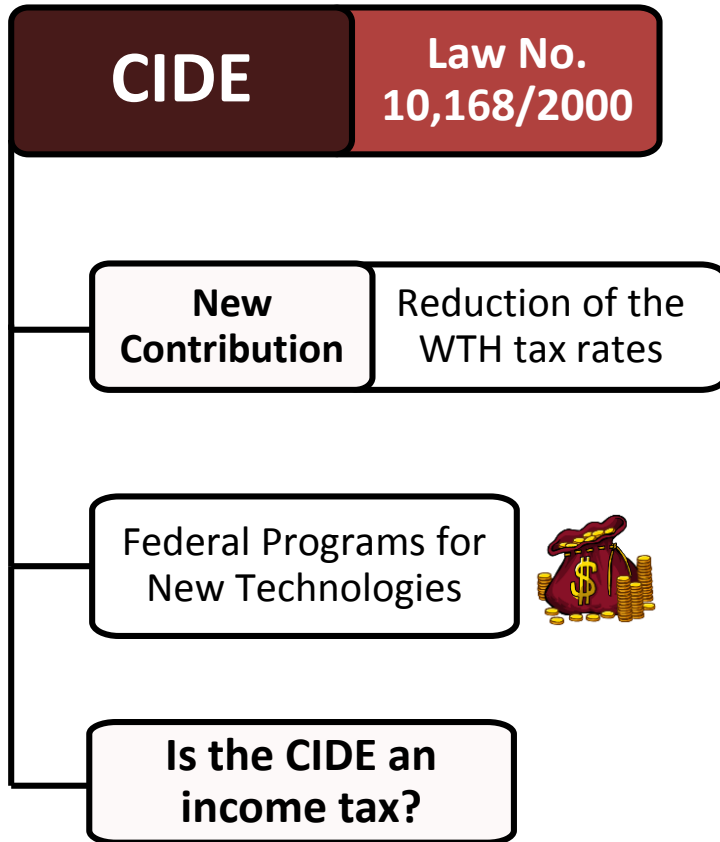
- Interpersonal shift of the tax burden is also achievable by any prohibition of the deduction of expenses at the level of the payer linked to an exemption at the level of the payee
 - Even though income is considered to be a net amount, a single gross element does not change the characterization of a tax
 - The prohibition of the deduction of expenses is part of the determination of the tax base in the source country.

EXAMPLE: BEPS action 4

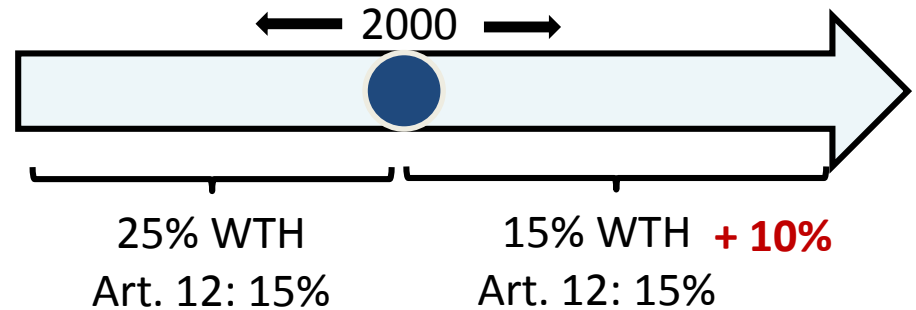


Brazilian Taxes: are they Income Tax? (LES)

Brazilian Taxes: are they Income Tax?



Taxation of technical services





Concept of Tax on Capital (WC)

Tax on Capital

- What is a tax on capital for treaty purposes?
 - Little elucidation in OECD MC language or Commentary
 - Taxes on “elements of capital” are taxes on capital
- Many actual bilateral treaties do not cover taxes on capital:
 - Australia, Japan , Korea made explicit reservations ; the U.K, and Singapore, etc. do not include capital taxes in treaties as a matter of policy.
 - Other countries, e.g. China and Russia, choose not to include capital taxes in most treaty coverage, even when they have no declared position and have taxes on capital.
- Some recent examples illustrate the importance of treaty coverage—all suggest that this can be an increasingly contentious area.

Tax on Capital

- Example 1: Belgian “annual tax on collective investment vehicles” or “net asset tax” (“NAT”):
 - When introduced in 1993, NAT only applied to Belgian CIVs; in 2003, scope extended to foreign CIVs operating in Belgium.
 - 2011 Brussels Court of First Instance case: Luxembourg CIV objected to the assessment of NAT because pursuant to Article 22(4) of the Belgium-Luxembourg treaty, taxes on capital could only be levied in the taxpayer’s State of residence.
 - Belgian tax authority’s surprising argument: NAT not a ‘tax on capital’ because not a tax on a taxpayer’s total capital.
 - Court: Article 2(2) defined ‘taxes on capital’ as “all taxes imposed on total capital, or on elements of capital”. For a Contracting State to interpret Article 2(3) as restricting the scope of application of the treaty is to interpret the treaty in bad faith.

Tax on Capital

- Example 2: Hungarian special tax on financial institutions: payable by banks on the amount of their total assets shown in 2009 financial statements (and the years since).
- Total assets or net interest and fee income may include assets and interest income attributable to foreign permanent establishments and thus taxed abroad. But no mechanism for exemption.
- As discussed, treaties specifically covering bank levies: UK with France, Germany and the Netherlands.



Concept of Tax on Capital: Capital v. Income Tax (AMJ)



Concept of Tax on Capital: Capital v. Income Tax

- Increasingly difficult distinction?: E.g.
 - ‘Tonnage tax’ CT tax (some countries), separate tax (others)
 - ‘Minimum asset tax’ included in CT some countries
 - Fictitious returns of capital based on ‘wealth’
 - Simplification (SMEs): integrated taxes (e.g. Russia) may also cover indirect taxes
- Trend to have ‘hybrids’ + call OECD to increase property taxes: conflicts + ad hoc solutions (new treaties: bank levies)?
- How to decide? Still needed to differentiate both (economic equivalence)?



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Distinction between Taxes on Income, Capital and Inheritance/Gift taxes (JH)



Distinction between Income Taxes and Estate Taxes

Historical division between Taxes on Income and Capital and Taxes on Estates, Inheritance and Gifts

- Need to draw a line because only a few inheritance and gift tax treaties in existence
- This political decision may not be neglected by wide application of treaties on income

Similarities and Differences between Taxes on Income and Estate Taxes:

- In both cases increment of property in the hands of the receiver; estates/gifts can be considered income
- Income tax = market transactions vs. estate tax = gratuitous transfer
- Taxes on income and capital = levied regularly vs. estate tax = specific transfers as single taxable events



Distinction between Income Taxes and Estate Taxes

Overlapping of Income and Gift and Inheritance Tax:

- The character of the tax does not change, if for single items the tax is triggered by a gift or by the death of the owner.

EXAMPLE:

Spain: Inheritance and gift tax applies only to gifts and estates of individuals.

Gifts and inheritances to corporations are subject to corporate income tax → does not change the character of the Spanish CIT

In other countries they are be covered by estate taxes.



Distinction between Income Taxes and Estate Taxes

Problems if Countries have integrated Inheritance Tax into Income Taxes

EXAMPLES:

Canada: Estate taxation as part of the income tax under the assumption that a deceased person liquidates all assets one minute prior to death

- Inequalities arising between Canada and a country that levies estate/ inheritance tax
- E.g., tax treaty US-Canada mitigates inequality through foreign tax credits (see para. 6 and 7 of Art. 29B of tax treaty US-Canada)

Germany: Inheritance tax reform proposal 10-10-model = integration of the inheritance tax into the income tax by a 10% income tax surcharge on income from transferred assets for a 10 year period



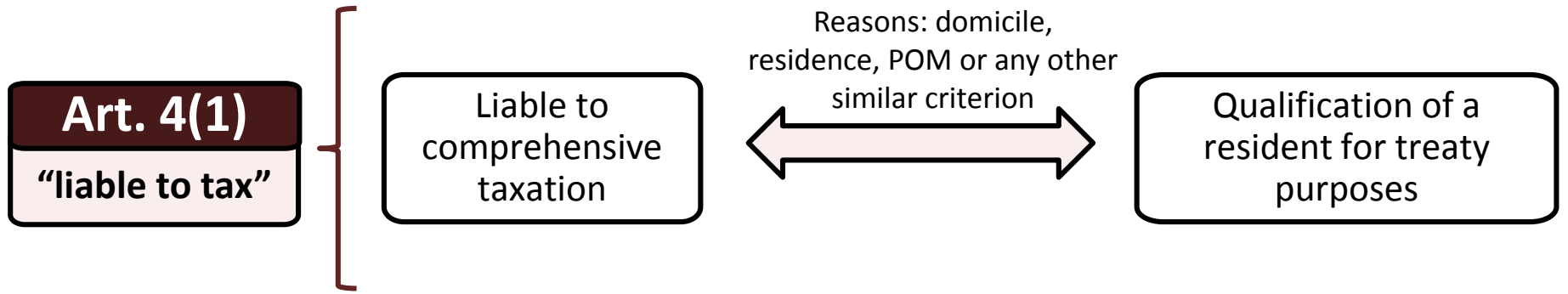
Part III

The Concept of tax (article 2 OECD MC) and Other Provisions (article 4 and 23 OECD MC)



Concept of Tax (Article 2) and Article 4 OECD MC: Liable to Tax (LES)

Art. 4: "Liable to tax"




Art. 4: "Liable to tax"

Art. 4(1)
"liable to tax" →




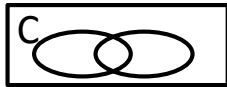
- Tax A
- Tax B
- Tax C
- Tax D

Vogel: "There is no basis for 'partial' treaty entitlement with respect only to a particular tax".

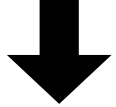
 High Court of Mumbai, Chiron Behring GmbH & Co

DTC-DE-IN

Art. 2 – German Trade Tax:
Under domestic law, it is payable by persons (e.g. partnerships) that are treated as transparent for income tax purposes 



Germany's resident for treaty purposes



It is entitled to the treaty rate of WHT on royalties and technical service

Problem

What was the residence criterion used?

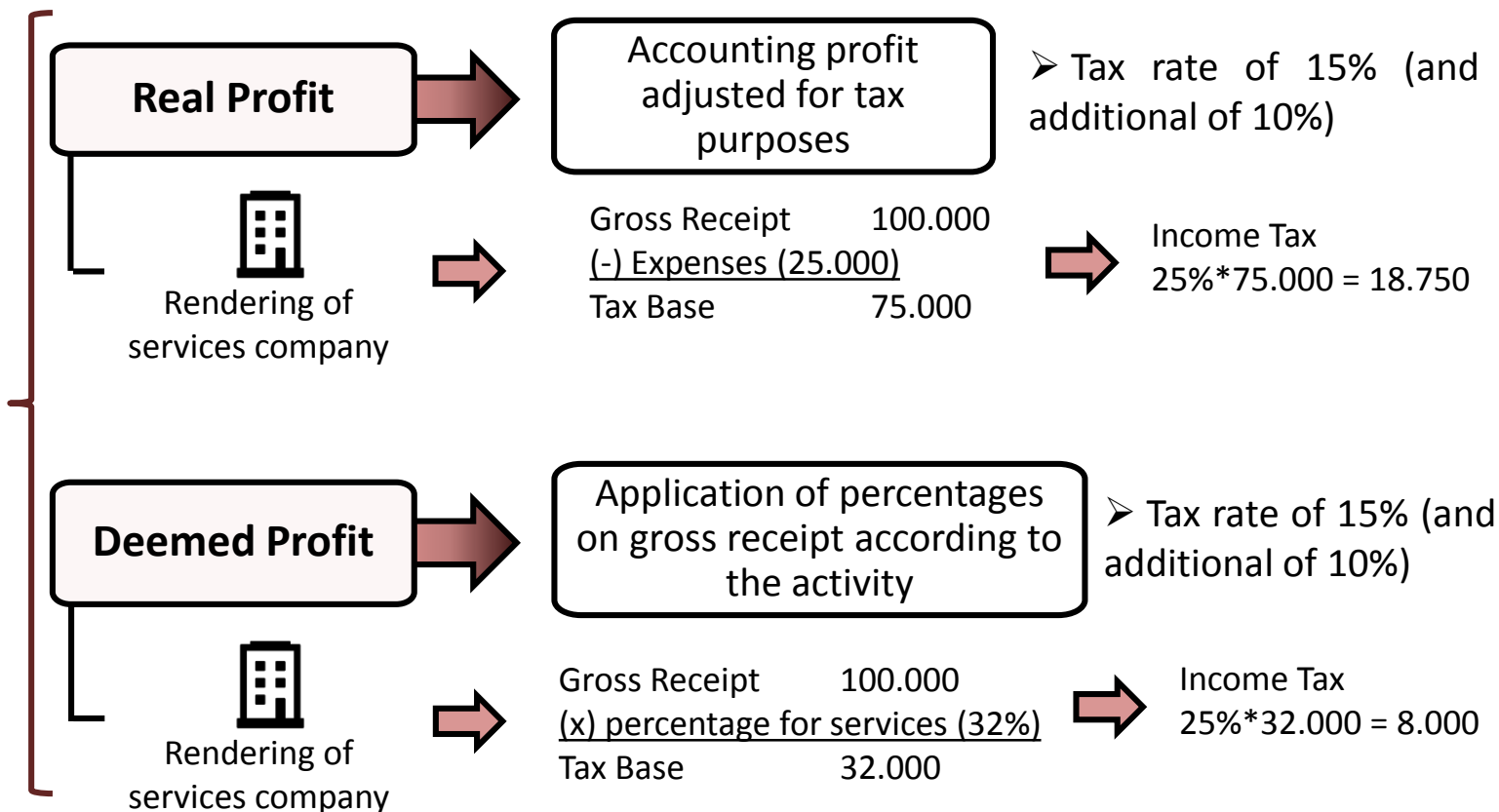
Art. 4: "Liable to tax"

Is the mode of calculation of the tax base relevant to the tax residence?

Example: Brazilian Corporate Income Tax



CIT





Concept of Tax (article 2) and Article 23 OECD MC (WC)



“Tax” in Art. 2 and Art. 23

- In general, the methods of eliminating double taxation under Art. 23 refer to the scope of taxes covered under Art. 2.
 - Exemption/credit is given in the residence country from/against covered (i.e. Art. 2) taxes if the right to impose covered taxes is allocated to the other country



“Tax” in Art. 2 and Art. 23

- However, Art. 2 may not fully stipulate the scope of Art. 23-creditable taxes. As usual, there is a spectrum.
 - Treaty methods of elimination of taxation may be exclusive and may narrow the scope of credit under domestic law: Finland
 - Treaty relief is fully “subject to the provisions of the laws of” a country. Japan: the church tax (Kirkollisvero), listed in the Japan-Finland Treaty, does not fall within the scope of “foreign corporation tax” and is thus not creditable against the Japanese corporation tax
 - Contrast with Canada: Canada’s treaties also provide for credit “subject to the provisions of the law of Canada”. However, because domestic law characterizations of whether a tax is imposed on income or profit defer to treaty law, the limitation is less severe



“Tax” in Art. 2 and Art. 23

- Art. 2 taxes not credited:
 - Argentina-Germany treaty provides credit only for the German income tax, despite the inclusion of other taxes (e.g. local trade tax) in Art. 2
- Inclusion in Article 2 for purposes of crediting:
 - 2008 Dutch-U.K. treaty: “the inclusion of the petroleum revenue tax...in [Art. 2] is solely for the purpose of permitting the Netherlands to give relief for these taxes under Art. 21”
 - Compare Norway-UK (2013): stating in Art. 2(4) that for credit purposes the UK petroleum revenue tax is covered in addition to the taxes covered mentioned in Art. 2(3)



“Tax” in Art. 2 and Art. 23

- The variety of taxes against which credit may be taken
 - Australia’s Elimination of Double Taxation Article refers to a credit being allowed against “Australian tax payable” in respect of income. Because the Medicare levy is deemed to be an income tax, foreign tax paid can be applied against the Medicare levy
 - Switzerland and Japan: municipal taxes normally included in Art. 2 and foreign taxes paid can be credited against them
- In contrast, Luxembourg and Belgium provide that the exemption method does not apply when it comes to resident country municipal taxes



Concept of Tax (article 2) and Article 23 OECD MC (AMJ)



Concept of tax art. 2 and art. 23 OECD MC

- OECD Comm. art. 23, para. 70 assume ‘symmetry’ concept of tax
 - Income taxes credited against income taxes,
 - Same rule capital taxes
 - Admits cases of cross-crediting in bilateral negotiations as exception (para. 71)
 - E.g. capital / specific taxes against income taxes
- Reality shows that ‘symmetry’ may not be perfect

Concept of tax art. 2 and art. 23

- Interpretation concept of tax income / capital may differ source-residence
 - E.g. Art. 2 v. domestic concept of tax for credit / exemption
 - Double taxation?
- Source country may look at what happens in residence country (conditions its tax policy)
 - E.g. Extractive industries
- 'Ad hoc' solutions:
 - In treaties or flexible interpretation concept of tax on income in residence country:
 - Incentive effect (double non-taxation, reduced taxation) if non comparable taxes compensated?



Article 2 and article 23 OECD MC: Example IRAP and US (PB)

IRAP – Principle or Pragmatism?

- The Italian IRAP was a local tax on trading income that disallowed most business deductions
- Under U.S. domestic law, would not be a creditable net income tax
 - Italian government was concerned that U.S. non-credibility would doom the tax
 - U.S. economists viewed the IRAP as a consumption tax
- Tax treaty effectively created a net income tax by giving credit for the amount of tax that would have been imposed if interest and labor expense deductions had been allowed



Part IV

The Concept of Tax on Income and Capital in the BEPS Era



BEPS and the Concept of Tax (AMJ)



BEPS: Assumptions

- No concept of tax / tax on income in BEPS context
- BEPS assumes:
 - traditional corporate income tax, and
 - permitted / reproachable 'double non-taxation'
 - Both: problems

BEPS and Corporate Income Tax

- Most actions narrow definition of ‘double non-taxation’, does not take into account other ‘taxes on income’ (covered or not by art. 2)
- Consequences:
 - Narrow concept of tax: BEPS applicable even if no double non- taxation?
 - Affects ‘transparency’ in CbCR (Action 13): excess / by default?
 - Affects material scope of tax treaties (action 6)
 - Concept of abuse Action 6 does not take into account all taxes (only CIT)
 - Abusive double non-taxation ‘not reverse’ of treaty double taxation, also requires to take into account taxes applied to payer, not covered by art. 2
 - Substantial change: action 6 unclear
 - Special Tax Regimes
 - Issues to be dealt with later (P. Brown, J.Hey)



BEPS and Elimination of Double non-Taxation

- Message fight against double non-taxation ‘legitimizes’ all kind of new ‘levies’ disregarding treaties?
 - Action 1 BEPS misleading message about when countries may create taxes ‘not affected by treaties’: equalization levies as options
- BEPS permits some forms of double non-taxation and prohibits others:
 - Legitimizes some actions by source State
 - Affects ‘structure’ of taxes: good / bad taxes
- Both trends will be studied:
 - Examples of taxes ‘to fight’ against double non-taxation
 - Impact of BEPS on the structure of taxes (STR, subject to tax clauses)



Double non-taxation v. art. 2: Indian Equalization Levy On-Line Advertising

- June 1st, 2016: new equalization levy effective
 - Taxable event: B2B payments to non-residents (no PE in India) for on-line advertising
 - Tax base: amount of payment
 - Tax rate: 6%
 - Taxpayer: non resident, but resident obligation to withhold (no withholding, no deduction of payment in income tax)
- Position in India:
 - Indirect and not income tax, levy independent of profits, not regulated in income tax law, justified by BEPS action 1
- But . . . contrary to art. 2 Indian treaties?
 - Context (PE taxation), structure (tax on gross income, direct relationship with income tax), suggests it can be
 - Narrow v. broad reading of art. 2?



Double non-taxation v. Article 2 OECD MC (UK DPT) (LES)

The UK DPT and the Concept of Tax



MNEs

Exploitation of the PE rules

**Diverted Profit
Tax**

1- Avoidance of the
characterization of a PE

2- Tax advantages

Use of transactions or entities that
lack economic substance

Ordinary tax
regime

20%

Diverted Profits
Tax

25%

➤ 1- The tax base corresponds to the profits that would have been attributed to the PE if its presence had not been prevented by the taxpayer.

➤ 2- The tax base corresponds to an amount equal to the additional profits chargeable to corporation tax in that period (not included; or TP rules)



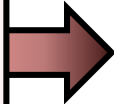
The UK DPT and the Concept of Tax

- “As a tax in its own right, **not corporation tax**, DPT has its own rules of notification, assessment and payment.” (HMRC Guidance on Diverted Profit Tax)

The UK DPT and the Concept of Tax

Is the DPT compatible with DTCs?

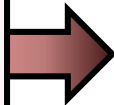
Art. 2



DPT is substantially similar to an income tax

- Similar tax base;
- Only different tax rate;
- It is directly connected with Art. 7 of the OECD-MC.

Art. 7



Problem: the UK intends to tax profits allegedly diverted, even without the effective characterization of a PE in its jurisdiction

- BEPS – Action 7;
- PE in UK law x PE in tax treaties;
- Tax treaty override?

Why would the DPT be creditable if the UK did not have the jurisdiction to tax under the DTC?



Concept of Tax: BEPS Action 6 and Special Tax Regimes (PB)



Concept of Tax and BEPS Action 6: Choosing Your Treaty Partner

- Report adds language to Commentary setting out policy considerations relevant to the decision to enter into a tax treaty which, not surprisingly, focuses on risk of double taxation
 - In order to determine whether there is double taxation, must first determine what is a tax
- According to Commentary, same considerations should be considered in deciding whether to modify or terminate an existing treaty
- In recent years, OECD members have increasingly entered into tax treaties with States that do not have traditional income taxes
 - Report is clear that decision to enter into such treaties is a sovereign decision



Concept of tax: Targeting Special Tax Regimes

- Under 2016 US Model, reductions in withholding rates on interest, royalties or “other income” would not be available to a beneficial owner entitled to benefits of a “special tax regime”
- Unlike earlier provisions that referred to specific regimes, new provision sets out a generic definition
 - Either provides preferential treatment for interest, royalties and guarantee fees as compared to the taxation of sales of goods and services or is ring-fenced
 - In the case of royalties, is not conditioned on research and development in that State
 - Is expected to result in low(ish) rate of tax
- Why is it bad for legislation to provide special rules for the taxation of interest and royalties, but a low overall tax is fine?



A Harmonized Concept of a Net Income Tax?

- “Bad” provisions are those that provide special benefits to financial or IT companies, not those of general application
 - Immediate expensing of capital expenditures
 - Special amortization rules
 - Certain research and development credits or patent box regimes that are not consistent with BEPS report
- Equally interesting are the exceptions -- pension funds, charities, collective investment vehicles, real estate investment trusts
- Detailed Special Tax Regime provision seems to set out U.S. concept of what constitutes a net income tax system – will it affect scope of covered taxes?
- Report on Action 6 suggests that STR provision will be included in OECD Model – do other countries agree with this concept of tax?



Does BEPS Define Concept of “Tax”, or Subvert It?

- More broadly, greater scrutiny of treaty partner’s tax base, not just rate
- What if treaty partner has exemplary provisions in its legislation, but simply doesn’t enforce the rules (such as thin capitalization rules)?
 - Is adopting BEPS rules essentially mandatory?
- Apple case demonstrates incoherence of current approach
 - United States argues that adherence to transfer pricing rules is only way to reach “right” result
 - On the other hand, BEPS concerns are causing tax authorities to do things that are not consistent with concept of an income tax, because revenues are being allocated without regard to where income is earned (inevitable result of the “cliff effect” created by PE threshold?)



Double non-Taxation, BEPS, Subject to Tax Clauses and the Concept of Tax (JH)



Double non-Taxation, Subject to Tax Clauses and the Concept of Tax

Subject-to-tax clauses' dual perspective:

- Subject-to-tax clauses by the residence country
Switch-over clauses (credit instead of exemption) if income is not or low taxed in the source country
 - Subject-to-tax clauses by the source country
Denial of deduction of expenses, exemption of certain items of income, or of a reduction of withholding tax if income is not or low taxed in the residence country
- In both cases: Which tax? Any of the taxes in Art. 2 OECD MC and beyond?



Double non-Taxation, Subject to tax clauses and the Concept of Tax

Features of ‘subject-to-tax clauses’:

- Wording: Interpretation of the phrases “liable to tax”, “subject to tax”, “taken into account for tax purposes”, “taxed”, “effectively taxed”?

see e.g., Weiser decision in UK: purposive interpretation

- Integration in the tax base is sufficient despite actual taxation, e.g., in cases where no tax is due because of a loss deduction.
- Identification of non-taxation or low taxation in regard to the taxation of the total amount of all items in one category of income or rather to each single item of income?
→ Problem of (very) low taxation

Double non-Taxation, Subject to Tax Clauses and the Concept of Tax

- **Meaning of “taxation” in a Double Non-Taxation situation?**
 - Detection of double non-taxation requires similar considerations like the detection of double taxation
 - A reason for a broader concept of tax in regard to double non-taxation could be that its prevention is limited to tax avoidance cases and aggressive tax planning.
 - Tax advantages and worthwhile tax planning activities will only occur if the item of income is not subject to any other equally burdening charge, which not necessarily needs to be a tax on income
 - Aim of DTCs cannot be to provide for a worldwide gap-less *income* tax system



Double non-Taxation, Subject to tax Clauses and the Concept of Tax

Contributions of BEPS?

- OECD: Action 2 –2015 Final Report:
 - As regards D/NI hybrid mismatch arrangements:
OECD recommends implementation of hybrid mismatch rules in domestic laws that provide for the inclusion of the payment in the ordinary income of the payee jurisdiction
→ Narrow concept?
- OECD: Action 6 –2015 Final Report:
 - OECD recommends clarification in the preamble of OECD MC that tax treaties are not intended to be used to generate double non-taxation
→ Broder concept?
→ Any burden?



Conclusions



General Reporter

- No universal notion of “tax” or “tax on income/capital”
- Hybrid taxes cause problems
- Comparability unclear
- Diversity in policies and interpretation

⇒ **factual double taxation and double non-taxation**

Solutions

- ⇒- New or improved legislation (e.g. MAP, arbitration)
- More co-ordination
 - Taxpayer friendly interpretation of double taxation relief provisions
 - BEPS



Conclusions of the Group: (I) International Tax Silos and Domestic Tax Policy

- Domestic tax reforms often guided by ‘domestic interest’ (regardless of tax treaties):
 - Mismatches between domestic taxes and treaty categories are frequent
- But sometimes also,
 - Domestic reform takes into account treaty categories to obtain relief in residence country
 - Economic double taxation, e.g. by changing the taxpayer can be the consequence of domestic reform
- BEPS creates additional tensions between national tax systems and Treaties



Conclusions of the Group: (2) Frailty of International Tax Relations, How to Fix it?

- Need to refine concepts of ‘double taxation, double non-taxation’ by working on concept of tax, tax on income / capital?
 - Incomplete versions not in line with article 2 (1) and 2 (2) can trigger double taxation
 - Current wording of article 2 does not solve all the issues. There is a need to work further on article 2 and the Commentaries
 - Need to work on the connection between article 2 and article 4 and 23 OECD
 - The issue of economic double taxation should be included in this work
 - Synergy with G-20/ OECD focus on growth friendly tax policies (22/09/2016)
- Proliferation of specific treaties (e.g. bank levies): helpful or more conflicts?
- BEPS confirms that it is time to revisit the concept of tax