Issues in Interpretation of Tax Treaties

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Focus: Obscure Rules with Major Consequences

- Article 3(2) – Undefined Terms
- The “non-aggravation” rule
- The U.S. “saving clause”
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.
“Non-Aggravation” Clause

• Article 1(2) of the 2006 U.S. Model:
  This Convention shall not restrict in any manner any benefit now or hereafter accorded:
  a) by the laws of either Contracting State; or
  b) by any other agreement to which the Contracting States are parties.

• Subject to anti “cherry-picking” rule that prohibits combining domestic and treaty rules “in an inconsistent manner”
“Non-Aggravation” if There’s No Clause

• Klaus Vogel: “It is a widely recognized principle of treaty law that DTCs, rather than being capable of creating new tax liabilities, can do no more than restrict existing ones.”

• Helmut Loukota of Austria describes it thus:
  – First, determine domestic treatment of the income or transaction
  – Then, determine whether the treaty limits the application of those domestic rules
Application of the Rules to Technical Services and Technical Assistance
Royalties: The Basic Definition

• Paragraph 11.3 of OECD Commentary distinguishes know how from services
  – Know how already exists
  – Services require future performance

• Royalties are payments for the “use or right to use” specified artistic or literary or intellectual property or know how
  – Accordingly, in the case of technology, there must have been a transfer of technology to the person making the payment
Right to Tax: General Rules

• Services – where services are performed
• Royalties – country of residence or, when the treaty provides for a positive rate of withholding tax, the country in which the payor is resident or in which a permanent establishment which bears the royalty is located
  – U.S. rule on royalties – where the intangible is used
Technical Assistance, Technical Services and Consultancy Services

• When included within the definition of royalties, allows taxation by the country where the payor is resident (or the permanent establishment is located) no matter where the service is provided.

• Included in most of Colombia’s treaties, even with countries that don’t usually ask for the rule, so must be important for Colombia.
What is Covered?

• Generally not defined in treaties
• No guidance in Commentaries to OECD or UN Models
• Accordingly, under Article 3(2), defined by state imposing the tax (the source State)
• BUT, what happens if the Source Country has no definition?
United States – Domestic Law

• U.S. can impose withholding tax only on “U.S. source” income
• Income from services will be U.S. source only if services performed in the United States
• But, most U.S.-source services income will be treated as “effectively-connected income” taxable on a net basis under domestic law
United States – Treaty Rules

• U.S. generally would treat services income as business profits
• But Article 7 says income that is specifically covered in another Article (such as Technical Services, etc., covered in Article 12) is governed by that Article unless attributable to a permanent establishment, in which case it’s back in Article 7
• Article 12 source rule also inconsistent with U.S. law
U.S. Conclusions

- “Non-aggravation” clause would allow taxpayers to apply more generous U.S. domestic law with respect to such payments
- Anti-“cherry-picking” rule means that a taxpayer that chooses to apply U.S. “effectively connected” rules to technical services, etc. may not be able to use the treaty “permanent establishment” rules with respect to other income
- In any case, United States generally limits “technical services” rules to cases where an intangible has been transferred
  - See Article 12 (Royalties and Fees for Included Services) of 1989 U.S.-India Income Tax Convention
Canada – Broad Source Taxation
(based on 2012 IFA Branch Report)

• Canadian domestic law imposes a 25% withholding tax on both:
  – “management fees” and
  – “services of an industrial, commercial or scientific character” where compensation is based on benefits, profits or production of goods
• Services need not be performed in Canada
• However, withholding tax not imposed on arm’s-length payments made to a non-resident in the ordinary course of its business
Canada – Treaty Rules
(based on 2012 IFA Branch Report)

• Under Canada’s treaties, services income generally treated as business profits so withholding tax would not apply if the income were attributable to a permanent establishment
  – Note, Colombia-Canada treaty includes a “services PE” rule

• However, at least with respect to management fees, Canada will impose withholding tax if the treaty has a specific provision to that effect
  – Query: Are “management fees” and “payments...for consulting services” the same?
Korea
(based on 2012 IFA Branch Report)

• Korea does not have a concept of technical services, etc., in its domestic law, so treated the same as other services
• Korean-source services income of a non-resident may be subject to withholding
• However, will be taxed on a net basis if attributable to a Korean permanent establishment
Taxing by Treaty

• Some countries, including Japan, France and possibly Korea, do not apply principle of “non-aggravation”

• Accordingly, it is possible that the inclusion of technical assistance, etc. rule, in Royalties article of Colombia-Korea treaty will allow Korea to tax such payments even when the services are not performed in Korea
Application of the Rules to Questions of Treaty Entitlement
Requirements to Claim Treaty Benefits

• Must be a “person”
• Must be a “resident”
• Must be the “beneficial owner” of the income with respect to which benefits are being claimed
• Must meet requirements of any anti-treaty-shopping provisions in the treaty
Beneficial Ownership Requirement

Why do we have it?

Conversely

IBM → U.K. Intermediary → Brazilian

IBM → Cayman Islands → U.K.
Beneficial Owner Requirement

• Not enough that income be paid to a resident
• Original explanation focused on receipt of income by “an agent or nominee”
• Later Commentary also suggests that conduit companies may not be the beneficial owner of income
Conduit company not normally the “beneficial owner” if it “has, as a practical matter, very narrow powers which render it a mere fiduciary or administrator ...acting on account of the interested parties” -- Paragraph 12.1 of the OECD Commentary on Article 10
Who Decides?

• Not defined in OECD Model or in most bilateral tax treaties.
• Article 3, paragraph 2, thus would allow the source state to define the term.
• However, at least some countries applied Paragraph 12.1 in questionable ways
  • Denied benefits to pension funds and collective investment vehicles because of obligations or incentives to pay out income received
  • Sometimes concluded that neither a trust nor its beneficiaries are beneficial owners
IndoFoods

Indonesia

20% Withholding Tax

Interest

European Bond Holders

Indofoods

10% Withholding

Interest

Mauritius Finance Sub

0% Withholding

Interest

International Fiscal Association
Bank of Scotland

USCo

3 year usufruct over preferred shares

Cash

Common Stock

New Preferred Shares

French Sub of USCo

U.K.
OECD Work on “Beneficial Owner”

• A first Discussion Draft on the issue was released in April 2011, with a revised draft released on October 19, 2012.

• Non-beneficial owner is a recipient whose “right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person”
  • Type of obligation must be related to the payment received.
Relation of “Beneficial Owner” Work to Article 3(2)

• What is basis for imposing limits on source State’s right to define the term?
• Must be a conclusion that “the context otherwise requires” some agreement on what the term means.
Application of Article 3(2) to Hybrid Entities
Canada Applies 3(2) to Deny Benefits
The OECD Partnership Report

- 1999 OECD Report on the Application of the OECD Model Tax Convention to Partnerships
  - Treaty benefits depend on whether the income received by the partnership is treated as the income of a resident of a Contracting State, either in the hands of the partnership or of the partners

- By its terms, is limited to things called “partnerships”
  - Attempt to extend reasoning to trusts proved too difficult

- Pragmatic approach, consistent with purpose of treaties, but not wholly consistent with Article 3(2)
Country X views the intermediate entity as a taxable resident.

Country Y views the intermediate entity as transparent.

**Partnership Report Example 17**

Country X

Country Y
Conclusions on Example 17

• Majority: “In its view, the situation involves a purely domestic matter from the perspective of State P; it is simply taxing the domestic source income of a resident taxpayer and nothing in the Convention can limit that right.”
  – This conclusion is reflected in proviso at the end of Paragraph 6.4 of the Commentary on Article 1

• Minority would apply the general principles set out above and give benefits.
Some Issues that might Arise under a New Colombia-U.S. Tax Treaty
U.S. Saving Clause

• Article 1(4) of the U.S. Model:
  “Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens...”

• Reference to the exceptions in Paragraph 5 ensures that certain negotiated benefits are indeed extended to U.S. citizens and residents.
Purpose of Saving Clause

• Traditional U.S. position is that the treaty partner should provide benefits to U.S. persons and the United States should provide benefits to treaty partner’s residents

• Treaty is not intended to provide U.S. benefits to U.S. persons
  – Obviously driven in part by U.S. taxation of citizens on worldwide income, even if resident in a treaty partner
Role of Exceptions to Saving Clause

• Exceptions to saving clause refer to provisions that are “intended to provide benefits to citizens and residents even if such benefits do not exist under internal law”

• Most exceptions relate to rules that provide an exemption from taxation in certain cases
  • Even if the relevant provision says that income can be taxed “only” in the other Contracting State, U.S. will still exercise taxing rights if the provision is not an exception to the saving clause
Effect of Citizenship Taxation on Definition of Resident

• Article 4 – definition of “Resident” includes person subject to tax on worldwide income by reason of “citizenship”
• Accordingly, a U.S. citizen resident in another country might be able to claim benefits under both countries’ tax treaties
• Many U.S. treaties include provision limiting the ability of a U.S. citizen to choose better of two treaties
  • See, e.g., Article 4(2) of 2001 U.S.-U.K. Income Tax Convention
Three Bite Rule – Article 23(4)

• Rule is intended to ensure that treaty partner does not bear the cost of U.S. citizenship taxation; if a U.S. citizen is a resident of the other Contracting State, that Contracting State should collect same tax as it would if the person was not also a U.S. citizen
  
  – First bite – U.S. is treated as if it collected the source-country tax
  
  – Second bite – other country imposes residence tax but relieves double taxation as if “first bite” tax actually paid to United States
  
  – Third bite – United States taxes on citizenship basis, but re-sources income; but see Savary case
Former Citizens and Long-Term Residents

• Concern that rich citizens were giving up U.S. citizenship and then selling U.S. companies (U.S. does not tax gains on the sale of shares in U.S. companies)

• Section 877 gives United States the right to tax an expanded class of U.S.-connected income for 10 years after expatriation
  – In 1996, expanded to cover certain long-term residents
  – Kept tweaking provisions to make them more “objective” and administrable
Mark-to-Market upon Expatriation

- As of June 16, 2008, the United States finally introduced a mark-to-market system.
- Citizens and long-term residents that meet certain tax or asset thresholds are treated as selling assets the day before expatriation.
- United States now seeks to include a “basis bump” so that the treaty partner does not tax the same gain when the taxpayer actually disposes of the asset.
Thank you!