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DOUBLE TAX PROBLEM

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INTERNATIONAL TAXATION AND TAX SYSTEMS/NPMZD

OUTLINE OF THE LECTURE

1. DOUBLE TAXATION
2. DOUBLE TAX RELIEFS AND METHODS
3. THE OECD MODEL TAX CONVENTION
4. THE US MODEL INCOME TAX CONVENTION
5. THE UN MODEL TAX CONVENTION

APPROACH TO DOUBLE TAXATION

- Many of the systems of double tax relief that are in place today were developed following the First World War, when many countries began to levy income/profit taxes for the first time or increase the rates to tax. This made the problem of double taxation more pressing. Because each country at the time was developing its own tax system independently, there emerged a difference in approach to relieving international double taxation.
- In Central Europe, a number of treaties were negotiated to relieve international double taxation, through an exemption mechanism (ie the country in which the taxpayer is resident doesn't attempt to tax profits earned outside of that country).
- A different approach was developing in the British Empire and in the US which was a credit mechanism where the country of the taxpayer's residence taxes all profits or income wherever in the world it was earned, but then gives a credit for any foreign tax paid.

THE BASIC PROBLEM

- Whenever a company or an individual undertakes activities in another country, they will be dealing with more than one set of tax rules and therefore there will be potential for international double taxation.
- The term double taxation refers to being imposed to tax more than once on the same profit or income.
- There are two types of double taxation, economic and juridical.

- **Economic double taxation** - is a broad term that covers any situation where an amount of income is taxed twice. For example it occurs when a single country taxes the same income twice (taxation of corporate profits: there are subject to corporation tax and when the post-tax profits are distributed to shareholders in the form of dividends are subject to income tax).

JURIDICAL DOUBLE TAXATION

- **Juridical double taxation** occurs where more then one country attempts to tax the same income.
- It arises specially because of a "jurisdictional" conflict in the rules that are used to determine residence or source.
- Sometimes it will occur because different countries use different rules for the same attribution of tax residence. For instance one country may use place of incorporation, and the other uses effective management and control, and both then claim jurisdiction over the same company.
- It could also occur if two countries have different rules about how to determine the source of income.
- Most commonly juridical double taxation occurs because a company or an individual has a source of income in a country other than the country of residence.
- The home country often taxes the income using the residence principle, and the foreign country taxes the income using the source principle.

DOUBLE TAX RELIEF

- This is term normally applied where the country of residence acts to prevent or reduce the extent to which its residents are taxed more than once.
- There are many different systems in use for achieving this end.
- Mechanism for the relief for double taxation are often set out in double tax treaties.
- These are bilateral (multilateral) agreements between pairs of countries in which the two countries set out how they will eliminate double taxation on their residents with respect to income or gains derived in the other country.
- These are governed by international law.
- In addition to use of double tax treaties, most countries normally set out provisions for unilaterally relieving double taxation on the residents in their domestic law.
- This ensures that relief for double taxation is available to cover income received from countries with which there is no double tax treaties.

METHODS OF DOUBLE TAX RELIEF

- **The deduction method**: under this method foreign taxes are treated as an expense of doing business. The country of residence taxes the foreign income, but allows a deduction for any foreign taxes paid.
- **The exemption method**: under this method, the country of residence doesn't tax the foreign income of its tax residents. Foreign income is said to be exempt.
- **The credit method**: here, the income earned from the overseas country is taxed in the country of residence. The foreign tax paid is then deducted from the tax on the income charged by the country of residence. Thus the country of residence gives credit for the foreign tax suffered.

METHODS OF DOUBLE TAX RELIEF

	No relief	Deduction	Exemption	Credit
Country B profits	1,000	1,000	1,000	1,000
Country B tax (35%)	350	350	350	350
Net after-tax profits	650	650	650	650
Country A tax on profits (30%)	300	---	---	300
Country A tax on after-tax profits (30%)	---	195	---	---
Credit for Country B tax	---	---	---	(350)
Total tax paid	650	545	350	300
Effective tax rate	65%	54.5%	35%	30%

METHODS OF DOUBLE TAX RELIEF

- When choosing which method or combination of methods to employ a country will need to consider the following factors:
  - capital export neutrality
  - protection of its tax base
  - the costs to the state and to taxpayers of the method adopted.

CAPITAL EXPORT NEUTRALITY

- It is the main reason for a country to try to prevent double taxation of business profits. The concept of neutrality is concerned with whether or not a tax is distortionary.
- Capital export neutrality will exist when there is no incentive or disincentive for resident investors to invest at home rather than abroad.
- This is achieved when a company’s total worldwide tax liability is the same whether a company is paying tax solely to its home government or to both the home government and foreign governments.
- Capital export neutrality is desirable as it permits expansion of a country’s business into overseas markets without a tax penalty, thus encouraging exports, bolstering a country’s foreign earnings and contributing towards the health of the county’s economy.

PROTECTION OF ITS TAX BASE

- The exemption method eliminates foreign income of residents from the tax base altogether.
- The principal danger of this method to a country's s tax base is that its residents will move mobile capital into other countries.
- Thus there is a tax incentive to deposit cash into foreign bank accounts and to invest in foreign rather than domestic companies so that interest and dividend payments and capital gains on sale of shares are exempt in the country of tax residence.
- Naturally the foreign country will be one where the rates of tax are lower than the country of tax residence.
- The credit method doesn't encourage the use of tax heavens, as if the taxes paid abroad are lower than domestic taxes on the foreign income there is home country tax to pay.
- The credit method therefore affords more protection to the domestic tax base than the exemption method.

THE COSTS TO THE STATE AND TO TAXPAYERS

One of the differences between the two methods relates to their complexity.
In its simple form the exemption method is very easy to operate, presenting few administrative costs to the country of residence.
The taxpayer only has to account one tax authority for the tax on the foreign income.
Because of the problem of flight of mobile capital to low-tax countries, many countries operate variants of the basic exemption method.
A common variant is the exemption with **activity clause** which only allows the exemption method to be operated in respect of income from foreign direct investment.
Income and gains from foreign portfolio investment are subject to a separate system of double tax relief by credit.
The credit method is more complex than the simple method of the exemption system as it requires a computation of tax on foreign income in the country of residence. All foreign taxes must be examined to determine if they qualify for double tax relief / foreign tax credit.

DOUBLE TAX TREATIES

- No two states have exactly the same tax systems. By entering into a tax treaty, a pair of states aims to minimize the extent to which a taxpayer will be subject to double taxation.
- The chief purposes of double tax treaties are to:
  - Provide a means of settling, upon a uniform basis, the most common problems which arise in the field of international juridical taxation,
  - Prevent evasion of tax, by making provision for exchange of information between tax authorities and for assistance in collection of the tax debts owed to the treaty partner,
  - Protect taxpayers against double taxation, direct or indirect, to a greater extent than the protection offered under domestic law,
  - Prevent tax from discouraging the free flow of international trade and investment and the transfer of technology,
  - Prevent discrimination between taxpayers,
  - Provide a measure of fiscal and legal certainty in international operations.

DOUBLE TAX TREATIES

- Tax treaties are bilateral agreements under which a pair of states, referred to as the **contracting states,** will decide how their tax systems will interact, so as to ensure that residents of each state get the double tax relief to which they are entitled.
- All tax treaties therefore contain a clause whereby the two states agree how they will interpret tax residence, to limit circumstances in which a person can find themselves dually resident and hence fully liable to tax in both states.
- Besides the key functions of providing relief for double taxation, a tax treaty will have provisions aimed at preventing tax avoidance.
- One other extremely important function of tax treaties is that they provide a mechanism whereby two states can interact in a relatively informal way so that double tax disputes and problem situations can be dealt with directly by the tax authorities of the two states.

TAX TREATIES AND DOMESTIC LAW

- Treaties are governed by international law rather than by domestic laws, usually under the **Vienna Convention on the Law of Treaties (1980)**. This Convention lays down rules for matters such as the territorial scope of treaties, general rules of interpretation.
- The general rule is that the provisions contained within treaties override those of domestic tax law. Some states specifically provide that subsequent changes in domestic law will, if they contradict the treaty, override the treaty.
- The central tenet of the Vienna Convention is that treaties are concluded "in good faith" and there is a presumption that a state will not want to override its treaties.

- Tax treaties can never make a taxpayer worse off than under domestic law.

TAX TREATIES AND EU LAW

- Within the EU there is a network of more than 300 bilateral double tax treaties which exist alongside the EU law.
- EU law for the tax purposes normally takes the form of Directives and the decisions of the Court of Justice of the European Union (CJEU).
- The relationship between this EU law and the domestic laws of the Member States is complex but in general, Member States are required to incorporate the provisions of the Directives into their domestic laws and to follow the decisions of the CJEU.
- The lack of co-ordination between treaty law within the EU and EU law itself they have different objectives: the former is to allocate taxing rights between a pair of states, and the latter is to help to establish the EU Single Market.

STAGES IN THE LIFE OF A DOUBLE TAX TREATIES

- It may take many years from the start the negotiations between two states to the date when a tax treaty into which they enter starts to be used.
- Sometimes treaties progress to the final stages but are never brought into use, perhaps because in the time it has taken to negotiate the treaty, the domestic tax law of the two states have changed significantly and the states are forced to “go back to the drawing board”.
- The key stages are as follows:
  - Signing
  - Entry into force
  - Effective date
  - Protocols to double tax treaties

A DEVELOPMENT OF A DOUBLE TAX TREATIES

- The first double tax treaty that applied to income taxes was entered into between Prussia and Austria-Hungary in 1899, and this treaty shaped developments before the First World War.

- The League of Nations Financial Committee was prevailed upon by the International Chamber of Commerce in 1919/1920 to examine the question of international double taxation:
- Which state has priority in taxing:
  - State of source?
  - State of residence?
- Should this differ depending on the type of income?

A DEVELOPMENT OF A DOUBLE TAX TREATIES

- The Committee arrived at three important decisions which form the basis of the rules governing a state's jurisdiction on tax today:

1. Profits of a permanent establishment of a foreign taxpayer could be taxed by the host state.
2. Tax residence depended on the place of centre of management.
3. Subsidiaries were to be treated as separate entities for tax purposes rather than as an integral part of the parent company.

The Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation (1935) was the forerunner of today´s tax treaties.

THE OECD MODEL TAX CONVENTION

- In the 1950s, the OECD was founded and took over the work of developing a model tax treaty.
- One of the principal aims of the OECD is to promote trade between its member nations.
- An important facet of its work is to assist in removing barriers to trade posed by taxation issues.
- It amended the 1935 model to take account of developments since that time and in 1963 published a draft Model Tax Convention on Income and Capital which has served as the model for double tax agreements between developed nations since then.
- By 1994, there were 225 treaties which are primarily based on the OECD model.
- The OECD Model is not binding upon any state but is usually used as the template for bilateral treaties, with the OECD's detailed Commentary on each of the Articles being used as supplementary data to aid interpretation.

THE OECD MODEL TAX CONVENTION

- The particular advantages of using an internationally accepted model include:

- Common rules of interpretation,
- A major aid to treaty negotiation – in terms of what should be included and also in terms of setting boundaries
- Certainty for multinational enterprises resident in a state using the OECD Model as to the uniformity of treatment regarding double taxation in all states in which they do business (although individual treaties may vary, such variations in the treaties concluded by a single state are usually small).

DOUBLE TAX PROBLEM

SUMMARY OF THE CONVENTION

TITLE AND PREAMBLE

CHAPTER I
Scope of the Convention

Art.	1	Persons Covered
Art.	2	Taxes covered

CHAPTER II
Definitions

Art.	3	General definitions
Art.	4	Resident
Art.	5	Permanent establishment

CHAPTER III
Taxation of income

Art.	6	Income from immovable property
Art.	7	Business profits
Art.	8	Shipping, inland waterways transport and air transport
Art.	9	Associated enterprises
Art.	10	Dividends
Art.	11	Interest
Art.	12	Royalties
Art.	13	Capital gains
Art.	14	[Deleted]
Art.	15	Income from employment
Art.	16	Directors' fees
Art.	17	Artistes and sportsmen
Art.	18	Pensions
Art.	19	Government Service
Art.	20	Students
Art.	21	Other income

DOUBLE TAX PROBLEM

OECD MODEL TAX CONVENTION

CHAPTER IV
Taxation of capital

Art. 22 Capital

CHAPTER V
Methods for elimination of double taxation

Art. 23 A Exemption method
Art. 23 B Credit method

CHAPTER VI
Special provisions

Art. 24 Non-discrimination
Art. 25 Mutual agreement procedure
Art. 26 Exchange of information
Art. 27 Assistance in the collection of taxes
Art. 28 Members of diplomatic missions and consular posts
Art. 29 Territorial extension

CHAPTER VII
Final provisions

Art. 30 Entry into force
Art. 31 Termination

THE US MODEL INCOME TAX CONVENTION

- The US uses an alternative model (the 2006 US Model Income Tax Convention).
- This model is based on the OECD Model but with some important difference.
- Being the leading world economy, the US is in a powerful negotiating position to insist upon its own model.
- It only has around 50 treaties (half the number concluded by the UK and the Netherlands).
- This wary approach is also evident in the content of its treaties: the US places great emphasis on “limitation of benefits” and doesn’t enter into “tax sparing” agreements in its treaties.
- Neither the exemption method of double tax relief permitted, only the credit method.
- This contrasts with the OECD Model which permits either.
- Another feature of the US Model is the “saving clause”, which preserves for the US the right to tax its residents and citizens even if they now reside in another contracting state (10 years after US citizenship is abandoned).

THE UN MODEL TAX CONVENTION

- The UN (United Nations) Model Tax Convention developed in 1980, favours capital importing states as opposed to capital exporting states and was developed for use between a developing state and a developed state.
- Although it is based on the OECD Model, more scope is afforded for the taxation of the foreign investor by the source of the state.
- The UN Model is designed to aid developing states to tax a larger part of the overseas investor’s income than the other two Models.
- It permits double tax relief by exemption and includes tax-sparing clauses.
- It permits withholding tax to be levied on royalty payments leaving the state whereas the latest versions of the other two Models do not.
- Model is the enhanced rights it affords the developing states to tax a part of the profits of multinational companies.
- An updated version of this Model was published in 2017.

ALLOCATION THE RIGHT TO TAX

- The rules dealing with the allocation of taxing rights between the two contracting states are referred to as distributive rules:
  1. Rules for certain activities such as business, agriculture, forestry
  2. Rules for income from certain types of assets such as dividends from shares, interest on loans, royalties paid for the use of intellectual property and rent from immovable property
  3. Rules which refer to capital gains
  4. Rules which refer to the status of the taxpayer involved, such as artistes, sportsmen and students
  5. A residual rule for income which does not fall under any of the previous four categories.

ALLOCATION THE RIGHT TO TAX

- Some categories of income may only be taxed in the state of the taxpayer's residence:
  - Business profits – unless there is a permanent establishment in the other state
  - Royalty income
  - Capital and capital gains – unless specified
  - Incomes from independent personal services where there is no fixed base in the source state
  - Private pensions
  - Certain foreign government salaries and pensions.