Tax Treaty Developments: Source versus Residence Principle

Prof. Dr Eric C.C.M. Kemmeren

Agenda

- Tax planning by MNEs in the main press
- Principles and policies
- Tax treaty subjects
- Business profits
  - Transfer of business profits
  - Interest
- Private pensions
- Concluding remarks
Tax Treaty Developments: Source versus Residence Principle

Vienna University of Business and Economics/29-03-2019

Prof. Dr Eric C.C.M. Kemmeren

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**Timetable**

- Morning:
  - 08:30 - 10:15: part 1
  - 10:15 - 10:45: coffee break
  - 10:45 – 12:15: part 2
- Lunch:
  - 12:15 – 13:45
- Afternoon:
  - 13:45 - 15:30: part 1
  - 15:30 - 16:00: tea break
  - 16:00 - 17:30: part 2
- Mode of instruction: interactive lecturing

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**Tax planning by MNEs: VPRO’s Backlight**

https://www.youtube.com/watch?v=tvlLO_pTimeY

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**Financial Times**

G20 governments agree to crackdown on tax avoidance

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Financial Times 08-02-2016
Multinational companies face tax avoidance EU crackdown

Apple hit with €13bn EU tax penalty over illegal Irish aid

Brussels has opened the door for European and US revenue authorities to claim a share of its €13bn recovery order from Apple after declaring the company’s Irish tax

US in last-ditch effort to quash Brussels tax demand on Apple
Principles and policies: agenda

- Legal principles
  - Qualitative principles
  - Quantitative principles
- Rationale of double tax conventions
- Economic policies
  - Export neutrality
  - Import neutrality
- Why switch from residence to origin?
Qualitative legal principles for allocating tax jurisdiction

- Principle of sovereignty
- Territory principle
- Ability to pay principle
- Direct benefit principle
- Principle of nationality (4)
- Principle of incorporation
  - Principle of residence (3)
  - Principle of source (2)
  - Principle of origin (1)
- Principle of functionality

Ability-to-pay timeline

Production of wealth ➔ Possession of wealth ➔ Consumption of wealth ➔ Disposal of non-consumed wealth

Income taxes (PIT, CIT, Wage Taxes) ➔ Net Wealth Taxes ➔ Consumption Taxes (VAT, environmental taxes, sales and use tax) ➔ Gift and Inheritance Taxes

Principle of source

- "Source" used in various meanings
  - Where property is located
  - Where property is used
  - Where services are performed
  - Where services have their effect
  - Where contract is signed
  - Where contract is executed
  - Whose laws govern contract
  - With which identity of payer is linked
  - Where payer is located
  - From where payment has been made
  - State which bears the expenses
  - Source = where person or property is physically located
Principle of origin

- Allocation of tax jurisdiction on income to a state if the income has been created through a substantial income-producing activity within the territory of that State.
- Origin of income:
  - Activity by an individual who adds the intellectual element to things
  - N.B. Source = origin
- Substantial activity:
  - Activity forms an essential and significant part of the activity as a whole

Quantitative legal principles for allocating tax jurisdiction

- Universality principle:
  - Taxation worldwide income/capital
  - Closely connected with
    - Principle of nationality
    - Principle of residence
- Territoriality principle:
  - Taxation of income produced in/capital situated in the state concerned
  - Closely connected with
    - Principle of source
    - Principle of origin
    - Direct benefit principle
    - Ability to pay principle

Rationale of double tax conventions

- Removing obstacles to the development of economic relationships between countries
- Promoting free
  - Exchange of goods
  - Exchange of services
  - Movement of capital
  - Movement of technology
  - Movement of persons
- Close connection with TFEU
Means to realize rationale of double tax conventions

- Focus on harmful effects of international juridical double taxation: mitigation of international juridical double taxation
- Mitigation of international economic double taxation
- Without creating opportunities for non-taxation or reduced taxation through
  - Tax evasion
  - More focus on as result of BEPS
  - Included in title and preamble of OECD/UN Models 2017
- Tax avoidance (including treaty shopping):
  - More focus on as result of BEPS
  - Included in title and preamble of OECD/UN Models 2017
- Elimination of discriminatory taxation
- Sharing tax revenues between states
- Strengthening of legal certainty for individual taxpayers
- Reduction of administrative procedures

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Economic policies

- Increase of worldwide prosperity
- Efficient allocation of production factors labour and capital
  - Allocating production factors where “they earn” the highest return
- Tax Neutrality
  - Taxation should not, or at least as possible, influence an efficient allocation of production factors
    - Capital (and Labour) Export Neutrality
    - Capital (and Labour) Import Neutrality

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Economic policies

- Capital (and Labour) Export Neutrality:
  - An income recipient should pay the same total (domestic plus foreign) tax, irrespective of whether he receives a given labour or investment income from foreign or domestic sources.
- Capital (and Labour) Import Neutrality:
  - Labour and capital funds originating in various states should compete on equal terms in the labour and capital markets, respectively, of any state, irrespective of the place of residence of the worker or the investor.
Economic policies in globalizing economies

- Production of income in globalizing economies
  - Business competes with business; not owners with owners
  - Employees compete with employees
  - Residents do not compete with residents
- In globalizing economies, the world is the production market
  - Trade-off is not domestic versus foreign investment
  - Trade-off is whether activity is done by foreign-based or domestic-based business
- CLIN increases efficient allocation production factors; CLEN not anymore
- CLIN supports an origin-based interpretation of ‘source’

Current dominance of principle of residence

- National law: resident versus non-resident taxpayer
  - Resident taxed on worldwide income/capital
  - Non-resident taxed on source of income/capital in territory
- Tax treaty protection: resident (Arts 1-4 OM/UNM)
  - Structure and allocation rules (Arts. 6-22 OM/UNM)
  - Residence State: unlimited tax jurisdiction
  - Source State: limited tax jurisdiction
- Methods for elimination of double taxation (Arts. 23A-23B OM/UNM)
  - Exemption method
  - Ordinary tax credit
  - Modified exemption system

Why should the principle of origin become dominant?

- Enhances principle of justice
- Enhances economic faculty principle/ability-to-pay principle
- Enhances direct benefit principle
- Enhances tax neutrality
- Enhances inter-nation equity
- Enhances opportunities to reduce economic gap in development between developing and developed states
- Enhances efficient allocation of production factors
- Reduces international juridical and economic double taxation
- Reduces (abusive) treaty shopping
- Reduces (abusive) rule shopping
- Reduces tax evasion
Source-based taxation and EU law: conflicting trends

- Towards an internal market
- Principle of open market economy with free competition (Art. 119/120 TFEU)
- CLIN best satisfies TFEU (Eurowings)
- Economic activity in EU = substantial income-producing activity (Factortame II, Cadbury Schweppes, Thin Cap GLO, X Holding, Philips Electronics, Itelcar)
- Case law supports CLIN and origin-based DTC
  - Schumacker, De Groot, Bossel, Saint-Gobain, Manninen, Marks & Spencer, Cadbury Schweppes, Thin Cap GLO, Oy AA, Lidl Belgium, Krankenheim Ruhesitz am Wannsee, Glaxo Wellcome, X Holding, Philips Electronics, K., Case 172/13 (EC v UK), Groupe Steria, Timac-Agro, X AB, Baudinet,
- Directives support residence-based taxation
  - Parent-Subsidiary and Interest & Royalty
- TFEU does not determine ‘source’
  - Member States are competent to determine the criteria for taxation of income and wealth (Gilly, Saint-Gobain, Bouanich, Damseaux, Beker, Miljoen, X (zaak C-283/13), N-Luxembourg)

Moving more to source-based taxation under DTCs

- Deficiencies by principle of residence
- Limitation on benefits in respect of residents
- International shipping and air transport
- Branch profit tax
- Double sources in case of interest/royalty payment effectively connected with PE
- Capital gains on shares in real estate companies
- Artists and sportsmen
- Private pensions
- Social security payments
- Other income
- Nondiscrimination of PEs and foreign-held subsidiaries
- Exemption method
- BEPS discussion

Tax treaty subjects: agenda

- Hybrid entity characterisation
- Eligible tax treaty subjects
  - Treaty shopping
  - Residence requirement under attack
  - Exit tax upon emigration
  - Origin-based tax treaty subjects
For assessment of transparency: tax treatment state of residence decisive
- Partnership level
- Partner level
- Source state may not vary from state of residence to deny treaty protection

Hybrid entity characterization (OECD)

State R

State S

Partnership P

Royalties

Not consistent, e.g.,
- Under source state rules partnership: non-transparent and a resident of source state
- Under rules state of residence partners: partnership transparent
  ⇒ Source state taxation not restricted by DTC S-R;
  ⇒ State R provides relief of double taxation
Hybrid entity characterization (OECD/BEPS)

  - Hybrid entity/arrangement (Art. 1(2) OECD Model/Art. 3 MLI/Art. 1(2) UNM)
    - Income derived by or through it
    - It is treated as wholly or partly fiscally transparent
    - Under tax law of either contracting state
    - Considered to be income of a resident of a contracting state
    - Only to the extent that the income is treated as taxable income of a resident of that State

Eligible tax treaty subjects

- Person who is a resident
- Tax treaty resident
  - Liable to tax = subject to tax?
  - Connecting factors for liable to tax
    - Domicile
    - Residence
    - Place of management
    - Any other criterion of similar nature
    - State, political subdivision, or local authority
    - Recognised pension fund of that State
- Limited taxpayer = tax treaty resident

Tax planning by MNEs: dividends

<table>
<thead>
<tr>
<th>State A</th>
<th>Corporation P</th>
<th>Dividend</th>
<th>WHT</th>
<th>State A (EU-MS/DTC-country/Third Country)</th>
<th>State C</th>
<th>Corporation P</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
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<td>70</td>
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<td>100</td>
</tr>
<tr>
<td>State C</td>
<td>Corporation S</td>
<td>Dividend</td>
<td>WHT</td>
<td>100</td>
<td>State C</td>
<td>Corporation S</td>
<td>Dividend</td>
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<td>Participation exemption</td>
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</tbody>
</table>
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**Tax planning by MNEs: interest**

State A (EU-MS/DTC-country/Third Country)

- **State A**
  - Interest: 70
  - Principal amount: 100

- **State C**
  - Interest: 100
  - WHT: 30

Interest of 100 is deductible under CITA

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**Tax planning by MNEs: royalties**

State A (EU-MS/DTC-country/Third Country)

- **State A**
  - Royalty: 70
  - License: 100

- **State C**
  - Royalty: 100
  - WHT: 30

Royalty of 100 is deductible under CITA

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**Limitation on Benefits Provision (LOB)**

- Settled tax policy of USA (latest version Art. 22 US Model 2016)
- Amendments of OECD Model as of 2017 to combat tax avoidance
  - Preamble (Art. 6 MLI): tax treaty intends to avoid creating opportunities for
    - Non-taxation or reduced taxation
    - Through tax evasion or avoidance
  - Including through treaty shopping arrangements
- Tax treaty residents are not entitled to treaty benefits, unless LOB test is satisfied (Art. 29 OM/Art. 7 MLI/Art. 29 UNM (more concrete))
  - No treaty benefits to a resident who is not a "qualified person"
  - "Qualified person" covers
    - Individual;
    - Contracting State, its political subdivisions and entities that it wholly owns;
    - Certain publicly-listed entities and their affiliates;
    - Certain non-profit organizations and pension funds;
    - Other entities that meet certain ownership and base erosion requirements;
  - Certain collective investment vehicles

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Limitation on Benefits Provision (LOB)

- Active conduct of business test
  - Non-qualified person
  - Engaged in active conduct of a business
  - In its State of residence and
  - Income emanates from or is incidental to that business
  - Item of income test (item-by-item test)
- Equivalent benefit test
  - Non-qualified person
  - Of which at least more than agreed proportion of that entity
  - Owned by certain persons
  - Entitled to equivalent benefits
  - Discussion Draft on non-CIV examples (06-01-2017)

Qualifying headquarters company

- Entity with safety-net decision
  - Discretionary authority of competent authority of contracting state (subject to judicial review (US Court of Appeals for the District of Columbia, Starr International Company v USA)

Definitions applicable for the purposes of other paragraphs

Dual residence

- Problematic
  - Tax treaty structure requires single place of residence
  - Income allocation rules predominantly based on distinction between residence State – source State
  - Residence State has unlimited tax jurisdiction
  - Double taxation remains
  - Possible double dip (two times loss deduction)
  - Solution by virtue of tie breaker rules

Tie breaker rules for dual residence

- Individuals (Art. 4(2) OM/UNM)
  1. Permanent home
  2. Center of vital interests
  3. Habitual abode
  4. Nationality
  5. Mutual agreement
- Mandatory ranking
- Non-individuals (Art. 4(3))
  1. Until 2017 OM/UNM: Place of effective management (POEM)
  2. Art. 4(3) OM 2017/Art. 4 MLI/Art. 4(3)UNM 2017: case-by-case solution by MAP
     - Place of effective management, place where it is incorporated or otherwise constituted and any other relevant factors
     - No MAP: no tax treaty relief or exemption, except to the extent agreed upon
     - POEM rule as alternative in OC/UNM

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Third party effect of tie breaker rules?

- HR BNB 2001/295
- BV incorporated in NL
- POEM of BV in NA
- BV dual resident under TAK
- Art. 34 TAK: BV is resident of NA
- Shareholder is resident of Belgium
- Dutch Hoge Raad:
  - BV is not a resident of NL
  - No full tax liability
- No certificate of residence for BV under NL DTCs with third state?
- Occasional ruling?
  - I.R.B. 111: yes
  - OC 2008: yes

Residence requirement under attack

- DTC can sometimes be invoked by non-resident
- Non-discrimination rule of Art. 24 (3) OM
  - PE entitled to credit of third state source tax on dividend, interest, or royalty
- EU law
  - Schumacker/Truck Center: acknowledgement of resident vs non-resident, unless taxable object of both is (nearly) the same
  - Saint-Gobain: DTC benefits not only for residents

Nondiscrimination rule (Art. 24 (3) OM)
Saint-Gobain

- DTCs testable against EU law
- Including DTCs with non-member states
- Allocated tax jurisdiction to be exercised in accordance with EU law
- Treaty benefits not only for residents, but also for non-residents with PE
- Secondary freedom of establishment is hindered
- No rule of reason for not granting treaty benefits
- Unilateral extension of treaty benefits: no violation of international law

Non-resident with PE eligible to DTC

- Saint-Gobain does not imply general obligation for source State
- Under circumstances it may be possible

<table>
<thead>
<tr>
<th>Company R</th>
<th>PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total profit: 100 -100</td>
<td>Total PE profit 100</td>
</tr>
<tr>
<td>Object exemption PE</td>
<td>Tax rate 30%</td>
</tr>
<tr>
<td>Source State</td>
<td>Tax credit DTC PE-S: 10%</td>
</tr>
<tr>
<td>Interest 100</td>
<td>Source tax DTC R-S: 15%</td>
</tr>
</tbody>
</table>

State S: 15% of 100 = 15
PE State: 30% of 100 - 10 (allowed State S tax) = 20
R State: taxable base = 100 - 100 = 0, so tax = 0

Total taxes on gross income of 100: 35
Exit tax upon emigration

- Exit tax
- Protective tax assessment
- Extension of payment
- Guarantee
- Introduction of exit tax contrary to a DTC?
- Convention = contract between states
- Unilateral change of balance in tax jurisdiction
- Contrary to Art. 26 + 27 Vienna Convention
- Exit tax contrary to EU law?

**Introduction of exit tax contrary to a DTC?**

Contrary to Art. 26 + 27 Vienna Convention

Exit tax contrary to EU law?

**De Lasteyrie du Saillant**

National Grid Indus, EC v. Spain (Case C-269/09), DI.VI.

EC v. Portugal (Case C-38/10), EC v. The Netherlands (Case C-361/11), EC v. Denmark (Case C-361/11), DMC, UNM

Rules liable to entail financial consequences

Principle of legal certainty (Telecart, SIAT, France Télécom, Euro Park Service)

- Rules must be sufficiently precise, clear and predictable as regards their effects

- Especially when they have unfavourable consequences for individuals and companies

Principle Purpose Test

(Art. 29(9) OM 2017/Art. 7 MLI/Art. 29(9) UNM)

**Art. 29(9) OM 2017/UNM 2017**

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

Principle Purpose Test

(Art. 29(9) OM 2017/Art. 7 MLI/Art. 29(9) UNM)

- General Anti-Abuse Rule (GAAR)
- On top of other DTC provions
- No treaty benefits if
  - Reasonable to conclude
    - Taking into account all facts and circumstances
  - Not necessary to find conclusive proof of the intent
  - Principle of legal certainty (Telecart, SIAT, France Télécom, Euro Park Service)
- Taxpayer must know precisely the extent of obligations which those rules impose on them
- Rules must be sufficiently precise, clear and predictable as regards their effects
- Especially when they have unfavourable consequences for individuals and companies
Principle Purpose Test
(Art. 29(9) OM 2017/Art. 7 MLI)

- General Anti-Abuse Rule (GAAR)
  - No treaty benefits if (continued)
    - Obtaining of treaty benefit is one of the principal purposes
      - Arrangement or transaction
      - Treaty benefit is direct or indirect result
        - Treaty benefit: Arts. 6-22, 23A/B, 24 OM
      - Objective analysis of aims and objectives of all persons involved
        - Term covers also provisions which use terms such as “main purpose” or “primary purpose”
      - Not required: sole or dominant purpose
    - Essential/principal aim (X&Y, Halifax, Cadbury-Schweppes, Kofoed, Part Service, Ampliscientifica, Foggia, N Luxembourg 1, T Danmark)

Principle Purpose Test
(Art. 29(9) OM 2017/Art. 7 MLI/Art. 29(9) UNM)

- General Anti-Abuse Rule (GAAR): LOB
  - No treaty benefits (continued)
    - Unless it is established that granting treaty benefit is in accordance with object and purpose of relevant DTC provision
      - Providing benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons (Art. 26 TFEU)
      - Opposed to arrangements whose principal objective is to secure a more favourable tax treatment
      - Burden of proof on taxpayer
        - In context of anti-tax avoidance law: burden of proof on tax administrations (Euro Park Service, Eqiom, N Luxembourg 1, T Danmark)


"2. General anti-avoidance rule based on a principal purpose test (PPT)
Where Member States, in tax treaties which they conclude among themselves or with third countries, include a principal purpose test based general anti-avoidance rule in application of the template provided for in the OECD Model Tax Convention, Member States are encouraged to insert in them the following modification:

"Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital unless it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that it reflects a genuine economic activity or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."
**Principle Purpose Test**
(Art. 29(9) OM 2017/Art. 7 MLI/Art. 29(9) UNM)

- Art. 29(9)OM 2017/Art. 7 MLI/Art. 29(9) UNM
  - Infringe open market economy with free competition, efficient allocation of production factors, tax neutrality, level playing field, international tax neutrality, capital and labor import neutrality, ability-to-pay principle, direct benefit principle, origin-based taxation
  - Hampers development of internal market

**Origin-based tax treaty subjects (individuals)**

- Citizen of contracting state subject to tax because of citizenship
- Resident of contracting state subject to tax because of residence, etc.
- Neither citizen nor resident, but individual
  - Who pursues/has pursued a substantial income-producing economic activity within the territory of the contracting state concerned
  - The income concerned has to be attributed to that activity on the basis of a functional connection
    - Functional connection: property is managed and its operations are directed and controlled from within the contracting state concerned and
    - State of origin is entitled to and will tax income functionally allocated to it as it taxes such income in the hands of its residents
  - Resident/citizen cannot invoke DTC of his state with other contracting state, if DTC of this state with state of origin applies

**Treaty subject**

- Austria
- Germany
- The Netherlands
Origin-based tax treaty subjects (non-individuals)

- It pursues/has pursued a substantial income-producing economic activity within the territory of the contracting state concerned.
- The income concerned has to be attributed to that activity on the basis of a functional connection.
- Functional connection: property is managed and its operations are directed and controlled from within the contracting state concerned.
- State of origin is entitled to and will tax income functionally allocated to it as it taxes such income in the hands of its residents.

Business Profits: Agenda

- DTC PE and EU Establishment
- Digitalized economy: an example
- From buy-sell to commissionaire/from commissionaire to low-risk distributor?
- Origin-based allocation of business profits

DTC PE and EU Establishment (art. 49 TFEU)

- ECJ Case 53/78 (Somafer)
  - Place of business
  - Appearance of permanency
  - Extension of parent body
  - Own management
  - Materially equipped
  - Negotiating business with third parties
- Comparison EU establishment with OECD PE
  - Human intervention with establishment; possibly not with OECD PE
  - No restricted geographical location like an OECD PE
  - Great similarity
Permanent Establishment and OECD/BEPS

- Actions 6 and 7 (2015): prevent tax treaty abuse
- Not intended to generate double non-taxation
- PE definition must be updated
- Flaws in PE definition used as tax planning tool
- Artificial fragmentation of operations among multiple group entities to qualify for exceptions under Art. 5(4) OMI
- Agency PE: commissioneer structure instead of distributor structure
  - Less profits attributable to local subsidiary which negotiates and concludes contract
  - No inclusion of service PE or insurance PE

Digitalized economy: an example

- Server of X
- No personnel of X

From full-risk-distributor to commissioneer/from commissioneer to low-risk-distributor?

- Distributor: Foreign seller
  - Contract in its own name
  - For its own account
  - Buy
- Local distributor
- Commissionnaire: Foreign principal
  - Contract in its own name
  - For account of principal
  - Sell

Supplement to physical PE

- Agency PE (Art. 5(5) OM 2017/Art. 5(5)(a) UNM 2017/Art. 12 MLI 2016)
- Person other than entrepreneur from one of the contracting states
- Not independent (Art. 5(6) OM 2017/Art. 5(7) UNM 2017)
- Acting on behalf of enterprise
- Habitually plays principal role leading to conclusion of contracts
  - That are routinely concluded without material modification by enterprise, and

Contracts are
- In the name of the enterprise, or
  - For
    - Transfer of ownership of, or
    - Granting of the right to use;
    - Property
    - Owned by that enterprise or
      - That enterprise has right to use,
    - For provision of services by that enterprise
  - Habitually concludes contracts,
    or

- Within territory of the other contracting state
- Nature of activities correspond to activities of enterprise
- No § 4 exception

Specific activity exemptions (Art. 5(4) OM 2017/Art. 5(4) UNM 2017/Art. 13 MLI 2016): exclusion of auxiliary and preparatory PEs

- PE under par. 1 or 5
- Facilities solely for storage, display, or delivery
- Stock/merchandise solely for storage, display, or delivery
- Stock/merchandise solely for processing by another enterprise
- Facility solely for purchasing goods/collecting information
- Facility for any other entrepreneurial activity
- Combination of foregoing
  - Activity or the overall activity (in case of combination) is of
    - Preparatory character, or
    - Auxiliary character
- Not applicable if
  - Same enterprise or a closely related enterprise (Art. 5(8) OM 2017/Art. 5(9) UNM 2017/Art. 15 MLI 2016)
  - Carries on business activities at the same place or at another place in the same Contracting State; and
  - That place is PE for the enterprise or the closely related enterprise;
  - Overall activity resulting from the combination of these activities is not of a preparatory or auxiliary character
- Provided that these business activities constitute complementary functions that are part of a cohesive business operation
- Not applicable to partnerships
Agency permanent establishment
(Art. 5(5-7) OECD MC 2017)

- Independent agent (art. 5(6-7) OM 2017/Art. 5(7) UNM 2017/Art. 12 MLI 2016)
  - Person acting on behalf of enterprise of other Contracting State
  - Carries on business, and
  - Acts in ordinary course of that business
- No independent agent
  - Person acts exclusively or almost exclusively
    - On behalf of one or more closely related enterprises
- Closely related enterprise (Art. 5(8) OM 2017/Art. 5(9) UNM 2017/Art. 15 MLI 2016)
  - Person has control of enterprise
    - Possession directly or indirectly of > 50% beneficial interest
    - Company: > 50% of aggregate vote and value of its shares
      or beneficial equity interest
  - Both enterprises are under the control of the same persons or enterprises
    - Possession directly or indirectly of > 50% beneficial interest
      - Company: > 50% of aggregate vote and value of its shares
        or beneficial equity interest
    - In person and enterprise
- Subsidiary not a per se agency PE

Agency permanent establishment
(Art. 5(5)(b)-(6) UNM 2017): extensions

- Art. 5(5)(b) UNM 2017
  - Person other than entrepreneur from one of the contracting states
    - No authority to conclude contracts in the name of enterprise
    - Nor plays principal role leading to the conclusion of such contracts
    - Habitually maintains stock of goods or merchandise in other State
      than residence State
    - From which regular deliveries
      - On behalf of enterprise
- Insurance PE (Art. 5(6) UNM 2017): deemed PE
  - Collecting premiums in other State than residence State
  - Insuring risks situated in that other State
  - Re-insurance is excluded
  - Activities through independent agent are excluded

EC position on OECD BEPS and PEs

  - Member States are encouraged in tax treaties which they conclude among themselves or with third countries, to implement and make use of the proposed new provisions to Article 5 of the OECD Model Tax Convention in order to address artificial avoidance of permanent establishment status as drawn up in the final report on Action 7 of the Action Plan to address Base Erosion and Profit Shifting (BEPS).
Profit attribution to subsidiary vs PE

- Arm’s length principle
- Functions performed
- Assets used
- Risks assumed
- Subsidiary: separate entity approach
- PE: separate enterprise approach
  - Risks assumed
    - Debtor
    - Stock
    - Currency
    - Transport
    - Guarantees
    - Liabilities
    - Bankruptcy
  - Functionally separate entity approach

Profit allocation to full-risk-distributor, commissionaire and low-risk-distributor

- Distributor
  - Foreign seller
    - buy
  - Local distributor
    - sell
  - Contract in its own name
  - For its own account

- Commissionnaire
  - Foreign principal
    - sales service
  - Local commissioner
    - sell
  - Contract in its own name
  - For account of principal
  - OECD (2018), Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7: Separate profit attributable to PE

Origin-based allocation of business profits

- Definition “enterprise”
  - An independent and durable organisation, which aims at participating in economic life by means of labour or a combination of labour and capital for the purpose of making a profit, which must reasonably be expected
  - Allocation to State in which an enterprise carries on or has carried on its substantial entrepreneurial activities
    - Substantial entrepreneurial activities
    - Relevant business activity forms an essential and significant part of the entrepreneurial activity as a whole
  - Attribution business profit to person for whose account the enterprise is carried on
Origin-based allocation of business profits

- PE and Agency PE disappear
- Introduction of “branch”
  - Entrepreneurial activity of an enterprise in the other contracting state which is carried out or has been carried out by individuals attributable to the enterprise, which in itself forms or has formed an essential and significant part of the activity of the enterprise as a whole
  - Activities of individuals attributable to enterprise if activities are for the account of the enterprise
  - Allocation of non-substantial activities to branches with which they are functionally most closely connected
- Application of arm’s length principle

Transfer of Business Profits: Agenda

- Dividend
  - Beneficial owner
- Capital gains on shares
  - Conversion of dividend into capital gains
- Origin-based distributions rules for transfer of profits

Dividend under Arts. 10 OECD/UN

- Residence state: unlimited tax jurisdiction
- Source state: limited tax jurisdiction
  - State of source is state of paying company
  - Beneficial owner is resident of other contracting state
  - Direct dividend: 5%/?% of gross dividend
    - Beneficial owner is a company
    - Directly owns/controls 25%/?% of capital, shares, stock, voting power, voting rights or similar ownership interests of paying company
    - Throughout a 365 day period that includes day of payment of dividend (Art. 8 MLI)
  - Portfolio dividend: 15%/?% of gross dividend
    - Reduction through exemption or refund
    - Influence of Parent-Subsidiary Directive
- Ordinary direct tax credit
**Tax Treaty Developments: Source versus Residence Principle**

**Vienna University of Business and Economics/29-03-2019**

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### Hoge Raad 06-04-1994, BNB 1994/217

(Royal Dutch): beneficial owner

UK Ltd. Stockbroker is beneficial owner

1. UK Ltd. Stockbroker became owner of the dividend coupon by purchase
2. After purchase, UK Ltd. could freely dispose of the coupon and the payments received
3. When cashing the coupon, UK Ltd. did not act as an agent or an unauthorized agent
4. To be assessed when dividend became payable
5. Holding shares was not required

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### Canadian Court of Appeal 26-02-2009

(Prévost Car)

- Shareholder’s agreement: not less than 80% of Prévost Holding’s and subs’ profits will be distributed
- Beneficial owner:
  - obliged to pay any dividend based on deed of incorporation
  - receives dividend for own use and enjoyment
  - assumes risk and control of dividend received
  - a person who, in fact, ultimately benefit from dividend (tax administration’s view)

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Beneficial owner

- Beneficial owner is clarification of term “paid [...] to a resident”?
- Immediate (direct) recipient
  - Agent
  - Nominee
  - Fiduciary
  - Administrator
- Reduction in source State
  - Immediate recipient located in other Contracting or third State; and
  - Beneficial owner is resident of other Contracting State
- Not a narrow technical meaning

Beneficial owner

- Context and object and purpose DTC
  - Avoiding double taxation
  - Prevention tax fraud and tax avoidance
- Owner of the income for tax purposes in the State of residence
  - Not a conduit for another person who in fact receives the benefit of the income concerned
  - Formal ownership not decisive if narrow powers in relation to the income concerned
  - Acting on account of the interested party decisive

Beneficial owner as of OC 2014

- Different interpretation by courts and tax administrations
  - Double and double non-taxation as result
  - Term to be interpreted in the context of “paid [...] to a resident” of Art. 10(1) OM
  - Not referring to technical meaning under domestic law
  - Meaning under trust law is not relevant
    - Trustee of discretionary trust or trust may qualify as beneficial owner on undistributed dividends
  - Term has autonomous treaty meaning
  - Agent, nominee, conduit company
    - Rights to use and enjoy received dividend are constrained; and
    - Dividend is not its own
    - Obligation to pass on dividend to another
Beneficial owner as of OC 2014

- Recipient is beneficial owner if he
  - Does have the right to use and enjoy the received dividend
  - Facts and circumstances (substance)
  - To be distinguished from legal ownership and use and enjoyment of shares
  - Unconstrained by contractual or legal obligation to pass on the payment received to another person
  - Legal documents
  - Facts and circumstances (substance)
  - Obligation must be related to payment received

- Term in DTCs has different meaning than in context of other instruments
  - (Individuals who have) ultimate (effective) control over entities or assets
  - Anti-money laundering rules
  - Corporate governance

Beneficial owner as of OC 2014

- No limitation of source State taxation
- Recipient is beneficial owner
- Abuse of Art. 10(2) OMC
  - Primary purpose of holding is taking advantage of this provision
  - Private investment and base companies
    - (Partly) held by shareholders outside the other Contracting State
    - Do not distribute their profits as dividends
    - Enjoy preferential taxation treatment
  - Other anti-abuse provisions or judicial concepts may be applied next to beneficial owner concept

Suggestion made: replace ‘beneficial owner’ by ‘effective beneficiary’

Effective beneficiary is
the person who is economic owner of the income, i.e., the person whose property has benefited from the income taken into account all economically connected receivables and liabilities and income streams.

- CJEU T Denmark/Y Denmark (PSD) and N Luxembourg 1/X Denmark/C Denmark I/Z Denmark (IRD)
- Term in OECD Models and Commentaries is relevant for interpretation of term in IRD,
- CJEU does not refer to 2014-OECD’s restrictive interpretation
- Term cannot refer to concepts of national law
- Beneficial owner
  - Not a formally identified recipient
  - Entity which actually benefits from the dividend/interest that is paid
to it
- Art. 1(4) confirms reference to economic reality
  - Entity which benefits economically from the dividend/interest received and accordingly has the power freely to determine the use to which it is put
  - Not conduit companies


- Beneficial owner (continued)
  - Conduit company
    - Its sole activity is receipt of dividend/interest and
    - Its transmission to
      - The beneficial owner or
      - Other conduit companies
    - Absence of actual economic activity
    - To be assessed in light of the specific features of economic activity in question
    - Analysis of all relevant factors relating, in particular, to
      - Management of the company
      - Its balance sheet
      - Structure of its costs and to expenditures actually incurred
      - Staff that it employs
      - Premises and equipment that it has


- Beneficial owner (continued)
  - A meaning that enables
    - Avoidance of double taxation and
    - Prevention of tax evasion and tax avoidance
  - Company that receives interest from conduit company
    - Is established in EU
    - Satisfies all conditions of IRD
  - Indications of arrangement to obtain improperly tax exemption
    - All or almost all of dividend/interest is, very soon after their receipt, passed on to entities which do not fulfil IRD conditions
    - Group structure: receiving company must pass dividend/interest on to a third company which does not fulfil IRD conditions
    - Receiving company makes only insignificant taxable profit when it acts as conduit company
### Beneficial owner under EU Parent-Subsidiary Directive + Interest & Royalty Directive

**continued**

- Indications of arrangement to obtain improperly tax exemption
- Contracts between companies involved
  - Aim of transferring profits from a profit-making commercial company to shareholding entities in order to
  - Avoid tax burden or
  - Reduce it as much as possible
- Way in which transactions are financed
- Valuation of intermediary companies’ equity
- Conduit companies’ inability to have **economic use** of dividend/interest received
- Indications are capable of being constituted by
  - Contractual or legal obligation of company receiving dividend/interest to pass it on to a third party
  - The **fact** that, in substance, that company, without being bound by such a contractual or legal obligation, **does not** have the right to use and enjoy those sums

### Beneficial owner under EU Parent-Subsidiary Directive + Interest & Royalty Directive

**continued**

- Simultaneity or closeness in time of
  - Entry into force of major new tax legislation which companies strive to circumvent
  - Setting up of complex financial transactions and grant of intragroup loans
- Existence of DTC between third State and source State does not rule out abuse of rights under EU law
- Alternative is to pay directly to entities in third State
  - If dividend/interest would have been tax exempt had it been paid directly, aim of group structure may not be abuse of rights

### Beneficial owner under EU Parent-Subsidiary Directive + Interest & Royalty Directive

- Impact of EU beneficial owner concept/abuse of rights on DTCs between EU MS?
  - Scope: refusing advantage from the EU rules
  - DTCs between MS are subject to Vienna Convention of Law of Treaties
  - Granting of tax treaty benefit may nullify refusal of EU benefits
  - DTCs must also be interpreted and applied consistently with EU law
9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

See further slides 49-54!

Capital gains on shares

- PE state if shares attributable to PE capital
- Specific rule on shares in real estate company
- Sometimes specific provision for substantial shareholding
- Otherwise state of residence alienator exclusive tax jurisdiction

Conversion of dividend into capital gain

- Alienation of shares to H is considered a capital gain
- Dividend payment from OC to H benefits from participation exemption
- Repayment of debt claim does not constitute income
- Anti-abuse law?
  - Alienation of shares to H is considered to constitute a (constituted) dividend?
  - Alienation of shares by Shareholder to H is ignored: dividend payment from OC to Shareholder?
  - If not, limited tax jurisdiction source state is avoided
- Inconsistent allocation rules of dividend and capital gains on shares
Principle Purpose Test
(Art. 29(9) OM 2017/Art. 7 MLI)

Art. 29(9) OM 2017/UNM 2017

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

See further slides 49-54!

Origin-based distribution rules: transfer of profits

- Transfer of profits
  - From company to shareholder: dividend
  - From branch to head office: dividend equivalent
  - Close connection between dividends and capital gains on shares
  - Origin-based allocation: State in which the business profits have been produced
  - Attuning tax jurisdiction on profits, dividends, and capital gains on shares to avoid juridical and economic double taxation
  - Shareholder’s State refrains from taxation
    - Tax base exemption
    - Tax credit
  - If dividends may be taxed, a branch profits tax should also be included
  - Reduction of relevance of the enterprise’s legal form

Origin-based allocation of transferred profits

- State O may tax 80 of 240
  - 100 /- 20 = 80
  - Allowed branch profit tax calc. 27.9% = 22.3
- State C may tax 160 of 240
  - (300 - 160) /- 40 = 160
  - Allowed dividend withholding tax rate: 37.5% = 60
- Total profit transfer tax
  - States O + C = 80 + 160 = 240
- Total Corporate income tax
  - States O + C = 20 + 40 = 60
- Total taxes States O + C = 150

Branch
Interest: Agenda

- Conversion of dividends into interest
- Origin-based distribution rules for interest and debt-claims
Interest under OECD/UNM (Art. 11)

- Residence State: unlimited tax jurisdiction
- Source State: limited tax jurisdiction
  - State of source is State of paying resident/PE
  - Beneficial owner is resident of other contracting State
  - See slides 75-90 on dividends
  - Maximum of 10%? of gross interest
  - Reduction through exemption or refund
- Ordinary direct tax credit

Conversion of dividend into interest

State A \[\text{Dividend} = 70\] State A \[\text{Interest} = 100\]

State C \[\text{Dividend} = 100, \text{Source tax} = 30\]

State C \[\text{Interest} = 100, \text{Source tax} = 0\]

Loan

Principle Purpose Test (Art. 29(9) OM 2017/Art. 7 MLI)

Art. 29(9) OM 2017/UNM 2017

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

See further slides 49-54!
Interest under OECD/UNM (Art. 11)

- Received interest effectively connected to PE: Article 7 applicable
  - UNM
    - Fixed base and interest: Art. 14 UNM applicable
      - Similar approach as in respect of PE and interest
    - Business activities similar to PE activities: Art. 7 UNM applicable (force of attraction)
      - Similar approach as in respect of PE and interest
  - No interest as far as interest amount exceeds arm’s length amount
    - Excess may classify as dividend

Interest (OESO/BEPS)

  - Interest on all forms of debt
  - Other financial payments economically equivalent to interest
    - Payments linked to financing of an entity
    - Determined by applying fixed or variable percentage to
      - Actual or notional principal
      - Over time
    - Other expenses incurred in connection with raising of finance
      - E.g. arrangement fees and guarantee fees
  - Recommended approach: limitation of net interest deduction based
    on fixed ratio rule, i.e. 10%-30% of entity’s EBITDA
    - Supplemented with worldwide group ratio rule: excess deduction
      - Main features similar to OECD’s recommended approach
        - Fixed ratio rule: 30% of entity’s EBITDA
        - De minimus rule: € 3,000,000 always deductible

Interest (OESO/BEPS) (continued)

  - Re-characterization of disallowed interest as dividend is problematic
    - Disallowance of interest expense is not allocated to specific payments
    - Financial payments economically equivalent to interest
    - Economic double taxation of non deductible interest
    - Risk of non-creditable WHT
    - Different rates of DTC (WHT) rates in source State
    - Re-characterization is not suggested as best practice
Origin-based distribution rules: interest and debt-claims

- Debtor is originator of the interest income
- Close connection between interest and capital gains on debt-claims
- Origin-based allocation: State in which debtor produces the interest income
- Reduces tension between equity and debt financing
- Mitigates (abusive) rule shopping
- Enhances tax neutrality
- Reduces tax fraud

Origin-based distribution rules: interest and capital gains on debt-claims

<table>
<thead>
<tr>
<th>State O</th>
<th>Deposit 100</th>
<th>State B</th>
<th>Bank</th>
<th>State R</th>
<th>Saver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entrepreneur</td>
<td>State O</td>
<td>Bank</td>
<td>State R</td>
<td>Saver</td>
<td></td>
</tr>
<tr>
<td>Interest 6.5</td>
<td>Interest 4.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Taxes in all States: 20%

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>State O - allows Entrepreneur deduction of 0.5</td>
<td>- 1.3</td>
</tr>
<tr>
<td>State B - may tax Bank on 0.5 x 6.0</td>
<td>+ 1.2</td>
</tr>
<tr>
<td>State R - (C(I)N) may tax Saver on 0.5</td>
<td>+ 0.1</td>
</tr>
<tr>
<td>(C(I)N) may tax Saver on 0.5</td>
<td>+ 0.1</td>
</tr>
<tr>
<td>State R tax - State O tax = Final State R tax - 1.2</td>
<td></td>
</tr>
<tr>
<td>does not waive tax jurisdiction if interest paid by Bank has not originated in State B or a DTC partner of State R</td>
<td></td>
</tr>
</tbody>
</table>

Private pensions: Agenda

- Private pensions
  - Residence-based system
  - Origin-based allocation of pensions
Private pensions (Art. 18 OECD/UNM)
- Pensions and other similar remuneration
- Widows’ and orphans’ pensions
- Other payments in respect of past employment
- Exclusive tax jurisdiction for State of residence of recipient
  - Paying State exclusively: payments under public scheme which is part of social security system (Art. 18 UNM, alternatives A + B)
  - Paying State non-exclusively: payment is made by resident or PE situated therein (Art. 18 UNM, alternative B)
- Tax driven emigrations
  - Strongly different residence-based systems
  - Possibly exit charges

Origin-based allocation of pensions

Concluding remarks

- CLIN and TFEU support origin-based DTC
- Origin-based double tax convention
  - Justified
  - Feasible
  - Improves EU’s internal market
  - Improves efficiency world economy
  - Enables developing states to reduce gap in economic development with developed states
  - Offers developing countries more opportunities than a Tobin tax or destination-based corporate income tax
  - Improves worldwide prosperity
  - Reduces BEPS