Lang

INTRODUCTION TO THE LAW OF DOUBLE TAXATION CONVENTIONS

3rd Edition

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Michael Lang

3rd edition

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Why this book?
Cross-border activities or transactions may trigger tax liability in two or more jurisdictions. In order to mitigate the financial burden resulting from these situations, states have entered into numerous double taxation conventions, which provide for rules that allocate the taxing rights between the contracting states.

This book provides an introduction to the law of double taxation conventions. Although principally aimed at students, irrespective of their national background, the book will be of value to tax experts who wish to learn more about double taxation conventions, as well as international law experts who wish to gain a better understanding of tax law. The book does not consider one jurisdiction in particular, but rather takes examples from a wide range of different countries and their jurisdictions. It includes an overview of the problem of double taxation, the state practice in the conclusion of double tax conventions and their effects, the interpretation of double taxation conventions and treaty abuse.

This revised edition takes into account new developments that have occurred since the previous edition of 2013, in particular the changes through OECD's BEPS Project and the Multilateral Instrument. It deals with the latest versions of the OECD Model Tax Conventions on Income and on Capital and the UN Model Double Taxation Convention between Developed and Developing Countries (both published in 2017), as well as the latest version of the OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts.

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Preface

The first edition of this book was published in June 2010, the second in September 2013. Since then, legislation, case law and academic discussion have developed further.

Accordingly, since the last version, this book takes into account the developments and recommendations from the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, changes of the new UN Model and OECD Model that have taken place in its more recent versions published in 2017, modifications on the application of some existing tax treaties according to Action 15 BEPS Project "The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (MLI), and the most recent judgments delivered by courts all over the world.

I would like to thank the entire team of the Institute for Austrian and International Tax Law that has considerably supported me over several months in the course of this project. Especially, research and teaching associates Cristóbal Pérez Jarpa, Xiangdan Luo, Jean-Philippe van West, Christina Dimitropoulou, Ioana-Felicia Rosca, Gabriela Capristano Cardoso, Martin Klokar, Florian Fiala, Raphael Holzinger, Svitlana Buriak, Andreas Ullmann, Annika Streicher, Claire Peng, Shimeng Lan, Clement Migai, Angelina Papulova, and Karol Dzwinski have worked intensively towards the publication of this book. I would like to thank them with all my heart for their excellent commitment and efforts as well as for their numerous critical remarks that have substantially enriched the contents of this book. Moreover, I am grateful to the publishing houses Linde (Vienna) and IBFD (Amsterdam), who have taken over this publication project. I am happy about this cooperation, which will ensure that the book will be available globally.

Vienna, November 2020 *Michael Lang*

Preface to the first edition

For many years now I have been holding lectures on the law of double taxation conventions. In the course of my teaching activities I have also developed relevant course materials. In 1997, these materials were compiled in a small book, which I first published in German. In 2002, the second edition of this book was released. From its conception, the book was aimed to provide both students and practitioners with the basic issues of the system and the application of double taxation conventions.

Originally published in German, the book now serves as a basis for this volume. It has been fundamentally edited and modified. Not only were the developments in international tax law that have occurred during the past 8 years incorporated but the contents of the book were also globalized: The book will be useful for all students and practitioners who are dealing with questions of double taxation conventions – irrespective of their national background. The book therefore does not consider one jurisdiction in particular but rather takes examples from a wide range of different countries and their jurisdictions. I hope that in this way it can be of help and use for students and practitioners from all around the world.

I would like to thank the entire team of the Institute for Austrian and International Tax Law that has considerably supported me over several months in the course of this project. Especially, the research and teaching associates Veronika Daurer and Oliver-Christoph Günther and the research associates Francesco Avella and Shauna Pitman have worked intensively towards the publication of this book. I would like to thank them with all my heart for their excellent engagement and efforts as well as for their numerous critical remarks which have substantially enriched the contents of the book. Moreover, I am grateful to the publishing houses Linde (Vienna) and IBFD (Amsterdam), who have taken over this publication project. I am happy about this cooperation, which will ensure that the book will be globally available.

Vienna, June 2010 *Michael Lang*

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1. The problem of double taxation

1.1. Basics of international law

1 States can levy taxes by virtue of their sovereignty. Tax sovereignty, however, is not unlimited. Not all situations can be taxed. There must either be **a personal or an objective nexus**, or connection, **between the taxpayer and the state**. With respect to a personal connecting factor, it is sufficient that this exists with respect to the person concerned. Connecting factors for individuals frequently include domicile, residence or citizenship. For legal entities, the factors usually include the place of incorporation and the place of effective management. With regard to an objective connecting factor, it is sufficient that parts of the transaction or activity involve the taxing state or that the object of the action is somehow connected to the taxing state.

2 In international law practice, there are no significant limits on the tax sovereignty of states. In designing the domestic personal tax law, the national legislator can even tax situations when, for example, only a "**genuine link**" exists. It is only when neither the person nor the transaction has any connection with the taxing state that tax cannot be levied.

3 **Example**

According to the Indian legal tax system, tax is levied when a "genuine link" exists. Pursuant to Sec. 9(1)(i) of the Income Tax Act, tax is levied on all income earned outside India which accrues, whether directly or indirectly, through or from any business connection in India. This principle formed the basis for the opinion of the Indian Authority for Advance Rulings (AAR) that a commission paid to a non-resident agent may be taxable in India even if the services are rendered outside India. Those services consisted of pursuing and soliciting the particiation of foreign concerns, undertakings and government departments in the International Food and Wine Show (IFOWS) in India. Although the activity of the agent was carried on abroad, the AAR observed that the agent's right to receive commissions arose in India when the foreign concerns, undertakings and government departments participated in the IFOWS. Therefore, the AAR considered that the agent's income accrued from a business connection in India (cf. IN, AAR 3 Jul. 2006, Rajiv Malhotra, AAR/671/2005).

1.2. Circumstances giving rise to double taxation

1.2.1. Taxation of worldwide income (full tax liability) in two states

4 Since international law places few limits on the tax sovereignty of states, the same event may be taxed in two or more states. Under many domestic tax law systems, a person's worldwide income is taxed if a close personal connection exists between the taxable person and that state (**universality principle**). This is called full tax liability. However, if the connection is weak or consists only of objective

factors, only the income earned in that state is taxed (**principle of territoriality**). This is called limited tax liability.

5 A taxable person can have close personal connections with two or more states. Under the tax laws of various states, for example, the person's domicile is a connecting factor. In others, residence and citizenship are connecting factors. Depending on the applicable laws, each of these criteria can lead to full tax liability. Therefore, it is not rare in practice, for the same person to be **subject to full tax liability in two or more states**. This can lead to the levying of taxes on worldwide income in two or more states.

6 **Example**

An individual who lives in Spain and whose centre of economic interests is in France is subject to full tax liability in both states. If there were no DTC between France and Spain, both countries would tax the person's entire worldwide income.

1.2.2. Full tax liability and limited tax liability

7 More frequently, persons are subject to full tax liability on the basis of their residence, citizenship, or any other criterion of a similar nature, in just one state and receive income from another state. In that other state, they are subject to limited tax liability. This limited tax liability applies only to the income earned in that other state. When the state of residence levies tax on worldwide income, the **income from the other state is taxed twice**. Thus, full tax liability in a state and limited tax liability in another can lead to double taxation.

8 **Example**

A person resident and domiciled in the United Kingdom and subject to full tax liability therein holds shares in a Swiss corporation. The person does not have a home or domicile in Switzerland. The person receives dividends from the Swiss shares. These dividends are taxed in the United Kingdom since the person is subject to tax there on his worldwide income. In Switzerland, limited tax liability exists. Consequently, the dividends are also taxed in Switzerland.

1.2.3. Limited tax liability in two states

9 Double taxation will usually not arise when a person is subject to limited tax liability in two states. Limited tax liability is based on the principle of territoriality. The two states will levy tax only on income arising in their respective territories. However, since the scope of the limited tax liability may not be the same in both states, double taxation may even arise **on the basis of limited tax liability**.

10 **Example**

A person lives in Italy and is subject to full tax liability therein. The person receives income from shares of a corporation that has its legal seat in Germany and its place of effective management in Belgium. The dividends received from these shares are subject to limited tax liability in Germany and in Belgium. The income would be taxed a third time in Italy on the basis of the person's full tax liability if the DTCs did not provide a remedy.

1.2.4. Economic double taxation

Thus far, the discussion has focused on double taxation arising from the taxation of the same person with respect to the same income in two or more states (juridical double taxation). However, it is also possible for the same income to be **taxed in the hands of different persons**. This situation is known as economic double taxation. 11

Example 12

The parent company of an unlimited company incorporated in the United Kingdom was a US corporation. The income of the UK unlimited company was taxable in the United Kingdom in the hands of the UK unlimited company itself. For US federal income tax purposes, the UK unlimited company was classified as a disregarded entity because it had a single shareholder, unlimited liability and had not made a "check-the-box" election. The income earned by the UK unlimited company was therefore considered to belong to the US parent corporation even if this income had not been distributed by the UK unlimited company. Thus, the income of the UK unlimited company was taxable in the United Kingdom and in the United States in the hands of the US parent corporation (cf. UK, SCITD 19 Nov. 2008, Bayfine UK Products v. Revenue and Customs Commissioners).

The problem of economic double taxation frequently arises in cases in which **affiliated or associated corporations,** with their legal seats in different states, enter into transactions with each other**.** Each residence state determines the taxable base for corporate income tax under its domestic corporate tax law. If the two companies enter into transactions with each other, the tax authorities of the two states could assign different values to those transactions (for a detailed description of transfer pricing issues, cf. m.no. 464 et seq.). Economic double taxation may then arise. 13

Example 14

A multinational group of companies has subsidiaries in China and Brazil. The Chinese company sells products to the Brazilian company for CNY 100,000. The Chinese tax authorities consider that the CNY 100,000 price is appropriate, whereas the Brazilian tax authorities are of the opinion that the appropriate price would be CNY 80,000. This may lead to economic double taxation.

1.3. Elimination of double taxation

1.3.1. Double taxation conventions

Cross-border economic relations would be considerably threatened if two or more states subjected the same income to taxation. Many states therefore enter into **bilateral international tax conventions** in order to eliminate double taxation. These agreements are called double taxation conventions (DTCs). They determine the extent to which each state may levy tax. 15

The number of DTCs is constantly growing. At present, **more than 3,000 DTCs** exist. For example, the Netherlands is party to over 90 DTCs, while Switzerland is party to over 80 DTCs and the United Kingdom has concluded more than 125 DTCs. 16

1.3.2. Unilateral measures

17 Notwithstanding the extensive DTC network, not all cross-border relations are covered by DTCs. However, many states enact **unilateral measures** to prevent international double taxation in cases that are not covered by DTCs. Unilateral measures to prevent international double taxation differ from country to country. Essentially, three types can be distinguished: the exemption of foreign-sourced income, the tax credit for foreign taxes paid on foreign-sourced income and the deduction from the taxable base of foreign taxes paid on foreign-sourced income. The United States, for example, unilaterally grants a tax credit for foreign taxes paid on foreign-source income.

18 The unilateral measures mentioned above are granted under approaches that also **vary from country to country**. Generally speaking, two approaches can be distinguished: in some countries (e.g. Germany), precise rules are set out in the law; in other countries (e.g. Austria), much leeway is left to the tax authorities. Unilateral relief from international double taxation is sometimes granted subject to reciprocity (e.g. Brazil).

19 In some countries, the unilateral measures' provisions only apply when a **DTC is not applicable**, either because no DTC is in place with the country where the income is derived from or because the personal (cf. m.no. 177 et seq.) or the substantive scope (cf. m.no. 220 et seq.) of the DTC is not fulfilled. In others, the unilateral measures' provisions also establish the details for the concrete **application of the methods** to relieve international double taxation provided for by DTCs. In the latter countries, therefore, the criteria set forth by the unilateral measures' provisions apply to determine the relief to be granted to a taxpayer under the applicable DTC.

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