Tax Treaties – How they work for effective tax planning

The first years of the 21st century have seen renewed interest and developments of a trusted 19th century vehicle for tax planning – the double taxation treaty.

Whether it will be adaptable to confront business models such as web-based commerce, and have the ability to do business without relying on traditional bricks-and-mortar, are still open questions. But, meanwhile, tax treaties remain useful tools for reducing the overall tax bite as companies, and the employees who work for them, continue to cross borders both in real and virtual terms.

History

First developed in 19th century Europe to reduce double taxation of an *ad valorem* nature between the Habsburg and Prussian spheres of influence, they formed a useful basis for dealing with double taxation of income when income taxes took hold in the early 20th century.

At that time, there were two camps – those who felt income should be taxed solely where an individual or a business enterprise was resident; and those who felt income should be taxed exclusively where it arose economically, even if the income recipient was not a resident. Linked to this was the fundamental question of what should be the tax target – someone or an item of income.

These debates would likely still be raging were it not for efforts of the League of Nations between the two World Wars, and eventual compromises which are still reflected in today's treaties.

The result is that:

- Some income items are taxed on residence, such as revenue from an enterprise's worldwide sales.
- Some are based on source, such as royalties from the use of intellectual property in a country other than the enterprise's country of residence.

How treaties work

Double taxation treaties are negotiated between countries and generally are based on one of three models:

- The first was created by the Organisation for Economic Co-operation and Development for use by its members. The model and interpretations are relied upon by many countries and updated regularly.

- Designed more with developing countries in mind, another model was created by the United Nations Commission on International Trade Law.

- Finally, there is the model developed by the US Treasury as the basis for negotiating treaties.

These models are the starting point for two countries to negotiate and arrive at a version that works for them. In the process, they agree that the treaty will take precedence over internal law, so that residents of contracting states enjoy lowered risk of double taxation when living, working, selling or transacting business in each others' states. Occasionally, new treaties replace old ones, or countries negotiate protocols amending certain articles of existing treaties.

While the model treaties have much in common, there are some striking distinctions, such as what constitutes a "permanent establishment", whether "tax sparing" is permitted, and whether citizens will be subject to tax even if they are not resident.

Here we focus on treaties applicable to business enterprises; the broad areas covered by treaties are:

1. Residence

Determining where a business enterprise (including a corporation, limited liability company or partnership) is resident for treaty purposes may not be as simple as it seems.

For companies, residence can also have duality: for example, when one country defines residence based on where a legal entity is incorporated or chartered, while the other country defines it based on where management and control are exercised.

Given today's technology, offering board meetings by teleconferencing from multiple countries and the ability to execute documents by computer, where management and control take place has become more difficult to determine. In the case of partnerships, or other flow-through entities for US tax purposes, residence may depend on where the *owners* or *members* are resident, rather than the *country* under whose laws the enterprise was formed.

2. Taxable presence

For a business enterprise from a contracting state, one of the most important considerations when entering a new market is whether the threshold has been crossed such that the enterprise is carrying on a business in the other contracting state. If so, it will become a taxpayer subject to income resulting from a "permanent establishment".

What constitutes a permanent establishment can vary significantly from treaty to treaty; those based on the United Nations model require a lower threshold of activity. Such a taxable presence can be triggered by several factors, such as renting office space and hiring employees; sending sales people to the country on a regular basis; providing equipment under a lease; having employees present at a construction site or drilling rig for more than six months; or hiring an agent to negotiate and enter into contracts.

While it may seem a bad thing to have a permanent establishment, in many cases it may yield favourable results – because a permanent establishment is subject to tax on its business profits (income less allocable deductions). Having a permanent establishment may result in a lower effective tax rate because you can deduct expenses, even when withholding rates are reduced by treaty.

3. Withholding on items of income

Even when an individual, or an enterprise, from one country is not resident in the other country, certain types of income will be subject to tax that is withheld by the person making the payment. For example, a royalty for the use of a patent in the other country will be subject to tax there through the mechanism of withholding by the licensee each time a payment is made. Other types of income subject to tax at source include interest, dividends, rents, capital gains and payments for services such as technical help. The benefit of a double taxation treaty is to reduce the rate of withholding (typically capped at 15%), or even eliminate it completely.

4. Relief from double taxation

A double taxation treaty may relieve a taxpayer in one country from taxation in the other country through, for example, exempting certain types of income from withholding tax. However, treaties include an article on relief from double taxation that is more comprehensive, and can result in the source country being permitted for tax, while the country of residence provides an exemption from tax on the income subjected to withholding, or permits the taxpayer to take a credit against tax in the country of residence on that same income. For this reason, it is important to know the rules on sourcing of income in the state of residence.

As an incentive for investment in emerging economies, several industrialised countries have included "tax-sparing" provisions in their treaties. These operate by providing a super-charged foreign tax credit as an investment subsidy. For example, if a resident of an industrialised country licenses technology to a developing country that reduces the rate of withholding tax under a double taxation treaty, the tax-sparing credit permits the licensor to take a credit as if tax had been withheld at a higher rate. The result is lower tax for the licensor granted by its country of residence for investing in the treaty country.

Treaties can still be invaluable tools for relieving double taxation in the area of transfer pricing. This is because "competent authority" relief is available in which the two countries' representatives agree on transactions between related parties where a transfer pricing audit has resulted in additional income in one country without a corresponding deduction in the other. (For more about transfer pricing see the UHY Global Transfer Pricing Guide, www.uhy.com)

5. Limitation on benefits

The US, in particular, has been keen to ensure that its tax treaties may be used only by a defined group of people who are considered entitled to the benefits of a treaty. As a result, all treaties in recent years have included a "limitation on benefits" article. For example, if a company incorporated in a low-tax jurisdiction, such as the Cayman Islands, and with a subsidiary in the US, were to set up a Dutch subsidiary to make loans to the US company and get a reduced rate of withholding tax on interest (from 30% to zero), the limitation on benefits article could negate the treaty benefits.

Relationship to other international treaties

Bilateral double tax treaties have sometimes to be interpreted and applied in the light of other international obligations. In the European Union, for instance, EU Directives often have a significant effect in the way certain intra-European transactions are taxed.

An important example of this is the EU Parent-Subsidiary Directive, which would take precedence over a treaty so that dividends from certain subsidiaries are not subject to tax in either country. Basically it exempts dividends paid by a subsidiary in a member state to a parent in another member state, from withholding tax at source. This applies irrespective of what the tax treaties between countries establish. It is important to note, however, that EU Directives are transposed to individual country legislation and, in the process, certain subtleties can be added with important effects intended to prevent tax avoidance.

Once correctly interpreted, the effect of this directive can be combined with holding company regimes in certain EU countries. "Participation exemption" reduces the impact of an international group's corporation tax to the lowest rate of tax in the dividend route from the profit-generating country to the holding company country.

Using treaties in tax planning

Beyond these basics there are many differences from treaty to treaty, not only as to which contracting state has the right to tax, but what other benefits and limitations are embodied in treaties. Therefore, it is essential for tax planners to read any applicable treaty in its entirety and to check for recent protocols when planning for taxation.

For example, a treaty may not provide for an exemption from tax on the sale of shares in the article covering capital gains, but an exemption or credit with respect to just such a transaction may be embodied in the article covering relief from double taxation. Similarly, a limitation on benefits in the case of withholding tax on interest may not appear in an article covering interest, but rather in an article limiting benefits – that is also separate from an article defining residence, which had been traditionally the basis for determining who could claim treaty benefits.

Treaties between industrialized countries (other than the US) and emerging economies often involve 'tax sparing' to attract foreign investment. While the tax treaty provides for a reduced rate of withholding payments such as royalties, the recipient in the industrialized country takes a tax credit as if the treaty were not in effect and higher tax was paid.

Future

The future of double taxation treaties appears bright as more and more are entered into, especially by countries whose economies are emerging and who are interested in attracting foreign investment. And while corporate tax rates have been dropping steadily in many countries over the last few years (with the notable exception of the US), this has not necessarily translated into lower withholding tax rates, so the attractiveness of treaties remains high for companies seeking to use foreign tax credits fully.

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