TAX LAW

Academic Year 2016 / 2017

AGENDA - Session 9-

- Investment Income

  Artt. 10 – 11 – 12 OECD MC

Required Readings:

- ***Artt. 10, 11 and 12 OECD MC***
- ***OECD Commentary on Art. 10 (paragraphs 1 through 39)***
- ***OECD Commentary on Art. 11 (paragraphs 1 through 36)***
- ***OECD Commentary on Art. 10 (paragraphs 1 through 19)***

Art. 10 OECD MC - Dividends

- Article 10 is a **bilateral** (distributive) provision i.e. it addresses taxation of dividends arising in a Contracting State and paid to a resident of the other Contracting State.

- It provides for **tax sharing** in that both the residence State of the recipient and that of the payor are entitled to tax the dividend.

Art. 10 OECD MC - Dividends

- Article 10, being ***lex specialis*** with respect to article 7, takes precedence over the latter article (Business Income).

- The article is merely concerned with the taxation of dividends by both Contracting States. How the beneficiary's residence should make allowance for source State taxation is a matter to be decided with reference to article 23A and 23B.

Art. 10 OECD MC - Dividends

- Article 10, par. 1, stipulates dividend taxation by the State where the shareholder, whether it be a private individual or any other person as defined in article 3 of the OECD Model, resides.
- The term **‘paid’** as used in the article is to be interpreted in a broad sense i.e. putting funds at the disposal of the shareholder.
- The term ‘resident’ as used in article 10, par. 1, is to be interpreted as **treaty resident**.

Art. 10 OECD MC - Dividends

- Article 10, par. 2, authorises source State taxation of the dividend albeit only at a limited rate. The tax so charged shall not, in fact, exceed the percentages set in article 10, par. 2.
- This paragraph does not settle the issue as to the **mode of taxation** of the dividend by the State of source.

Art. 10 OECD MC - Dividends

- The Model Convention provides for different maximum rates of withholding tax, depending on whether **inter-company dividends** (direct investments or income from entrepreneurial holdings) or dividends from **portfolio investments** are involved.
- The article does not mention a **minimum holding** period the parent company must have held on to the holding in the subsidiary to get access to the treaty-reduced rate.

Art. 10 OECD MC - Dividends

- Treaty benefits (reduced taxation in the country of source) are available only in so far as the **beneficial owner** of the dividend is resident in the other Contracting State.
- The term is to derive its meaning with reference to the **context of the treaty**, and particularly with a view of the **purpose** pursued by the restriction.

Art. 10 OECD MC - Dividends

- The requirement of ‘beneficial ownership’ is aimed at denying treaty benefits whenever an intermediary (**<u>such as</u> an agent or a nominee,** in keeping with the language employed by the OECD Commentary) is interposed between the beneficial owner and the company paying out the dividend merely to enable the beneficial owner to get access to treaty protection otherwise undue.

Art. 10 OECD MC - Dividends

- The dividend definition consists of three parts:
  - from **shares**, **'jouissance' shares** or **'jouissance' rights**, **mining shares**, **founders' shares**;
  - from **other rights**, not being debt-claims, **participating in profits**;
  - as well as from **other corporate rights**, to the extent that such income is **subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident**.

Art. 10 OECD MC - Dividends

- Article 10, par. 4, provides for an exception to the general rule laid down in paragraphs 1 and 2 whenever the holding in respect of which the dividends are paid is effectively connected with a permanent establishment that the recipient maintains in the State of the payor.
- More appropriately it is a restoration of a rule (Art. 7) rather than an actual exception .

Art. 10 OECD MC - Dividends

- The source State instead of taxing the gross amount of the dividend is indeed entitled to tax only the **net amount** thereof. At the same time the source State encounters no restriction for what concerns the level of the rate of tax applied.

Art. 11 OECD MC - Interest

- Article 11 is a **bilateral** provision dealing with taxation (it envisages **tax sharing** i.e. concurrent taxation by the State of source and that of residence) of interest <u>arising in a Contracting State and paid to a resident of the other Contracting State</u>.
- Article 11, being ***lex specialis*** with respect to article 7, takes precedence over the latter article and thus it supersedes the business income principle.

Art. 11 OECD MC - Interest

- Article 11, par. 1, authorises taxation by the residence State of the recipient. The residence State of the recipient taxes the interest without being restricted in doing so.
- While the source State taxes the gross receipt, no deduction being allowed for expenses incurred by the taxpayer, the residence State of the investor imposes tax on the basis of the net income thereby creating a risk of **excess foreign tax credit**
- The term ‘**paid**‘ should be given a broad

Art. 11 OECD MC - Interest

- The term ‘**paid**‘ should be given a broad interpretation so as to mean **the fulfilment of the claim to receive interest** in any form it may actually occur e.g. performance in kind or off-set of mutual claims.

- The State of source taxes the interest (‘**such interest**’ as defined in article 11, par. 3, but only **at a limited rate**.

Art. 11 OECD MC - Interest

- The tax facility represented by the reduced rate in the source State is available only in so far as the **beneficial owner** is a resident of the other Contracting State.
- The term recipient should be given a broad interpretation: whenever the interest is disbursed to an intermediary nonetheless the payment is deemed to have been effected to the beneficial owner as well.

Art. 11 OECD MC - Interest

- In general terms interest means **remuneration received for making capital available** (income from debt-claims of every kind) and does not include profits from providing funds in cases where the **provider accepts the hazard of the borrower's business**.
- The existence of an **underlying claim** is the main feature of the OECD Model interest definition

Art. 11 OECD MC - Interest

- **Thin capitalisation** rules have been devised to prevent tax avoidance stemming from the interest deductibility coupled with tax-favoured treatment of interest receipt.
- In principle whenever a loan is regarded as being a concealed capital contribution e.g. **shareholder's loans,** the interest relating to such indebtedness is treated as a dividend. The effects of this re-characterisation are twofold:
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Art. 11 OECD MC - Interest

- The effects of this re-characterisation are twofold:
  - it increases the company' profits given the non deductibility of dividends; and
  - domestic rules relating to dividend therefore apply.
- It has to be noted, however, that taxation of 'distributions' remains geared to article 11, unless the treaty too converts interest into dividends (interest must arise from 'corporate rights').

Art. 11 OECD MC - Interest

Paragraph 4 of Article 11

- Reference is made to the comments made on article 10, par. 4, which, *mutatis mutandis*, apply with respect to interest.

Art. 11 OECD MC - Interest

- Article 11, par. 5, complements article 11, par. 1, by furnishing the definition of the term '**arise**' as used in the first paragraph of the article at hand.
- Interest arises in a Contracting State if **the payer is a resident** thereof. A Contracting State, a political subdivision or a local authority thereof fall within the definition of resident. The payer is who owes the interest under **private law**.

Art. 11 OECD MC - Interest

- Article 11, par. 6, defines interest as regard its amount as the *quantum* of interest that would have been agreed upon absent any **special relationship** between the payer and the beneficial owner or between those two and some other person.
- Thus the interest article applies only with respect to the **reasonable interest** i.e. that not exceeding the arm’s length consideration.

Art. 12 OECD MC - Royalties

- Contrary to article 10 and 11 which provide for concurrent taxation by the source State and that of residence, article 12 assigns **exclusive taxing rights** to the residence State of the investor (whether it be private individual or business enterprise).
- The term '**paid**' should be broadly interpreted so as to include all forms of fulfilling the obligation to satisfy claims to royalties.

Art. 12 OECD MC - Royalties

- Exemption at source is granted only in so far as the **beneficial owner** of such payments is resident of the other Contracting State.

- Treaty application depends on the beneficial owner's entitlement to such benefits (*i.e.* on his being resident in the other Contracting States).

Art. 12 OECD MC - Royalties

- Article 12 defines the term ‘royalties’, which encompasses **payments of any kind** (including money or money’s worth and lump sum payments) <u>received as consideration</u> **for the use of, or the right to use** any copyright of **artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process or for information concerning industrial, commercial or scientific experience.**

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