LIUC – Università Carlo Cattaneo

International Tax Law

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The concept of residence and tax residence of individuals

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OECD Model Convention (MC) Application

- Who can apply a tax treaty?
- Article 1(1) of the OECD Model Convention:

"*This Convention shall apply to persons who are* ***residents*** *of one or both Contracting States*"

- "Resident" status is crucial for treaty application

OECD Model Convention (MC) Application

- Why is it important to define the residence of a taxpayer?
- Residents of a State are generally taxed on both their domestic source income and their income derived from outside the State.
- Non residents are taxed only on income derived from a State.
- Ref. previous lesson: World-wide taxation vs. territorial taxation

OECD Model Convention (MC) Application

- The tax policy justifications for taxing resident taxpayers on their worldwide income are <u>equity</u> and <u>neutrality</u>.
- If two residents have equal amounts of income, they should be subject to the same tax burden (equity).
- A State should not create a tax incentive for its residents to work or invest outside the country: if the foreign source income of residents is not subject to residence country tax, residents have an incentive to earn low-tax foreign source income in preference to domestic source income (neutrality).

Defining residence

- For the purpose of taxing residents and non residents, a State must provide specific rules defining individuals and legal entities either as residents or non residents.
- The rules defining residence are clearly necessary for taxing residents on their domestic and foreign source income, but they are also necessary for taxing non residents on their domestic source income.

Dual-resident taxpayers

The claims of States for tax revenue based on residence jurisdiction may also overlap with the claims of other States based on citizenship or, in the case of so-called «**dual-resident taxpayers**», on residence.

Resident for part of a year

- Special rules may be necessary if a taxpayer is resident of a country for only part of a year.
- As a result, some States have rules to tax part-time residents on their world-wide income for only the portion of the year during which they are actually resident (**split-year systems**).
- The new State of residence should provide the taxpayer with personal allowances for the balance of the year.

Residence Definition: Art. 4 OECD MC

The concept of «resident of a Contracting State» is defined in Art. 4(1) of the OECD MC:

“For the purposes of this Convention, the term "resident of a Contracting State" means any person who, ***under the laws of that State****, is* ***liable to tax therein by reason of*** *his domicile, residence, place of management or any other criterion of a similar nature”*

→ 4(1) OECD MC Refers to domestic legislation

→ Indirect reference to world-wide tax liability

The concept of «*resident of a Contracting State*»

- Double tax treaties do not normally define the concept of residency, for which taxpayers shall refer to domestic laws.
- Art. 4 is meant to establish in double tax treaties which of the two concepts of residence is to be given preference.

The concept of «*liable to tax*»

- Art. 4(1) makes reference to persons who are liable to tax by reasons of various criteria (domicile, residence, place of management or any other criterion of a similar nature).
- In many States a person is considered «liable to tax» even if the Contracting State does not *de facto* impose taxes on that person (e.g. charities and other organizations may be exempted from tax, but they are exempt only if they meet all the requirements specified by the laws: they are, thus, subject to tax laws of a Contracting States).
- In some States, however, these entities are not considered liable to tax if they are exempt from

Residence Definition Art. 4 OECD MC

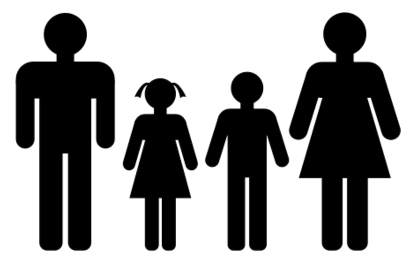
- Article 4(1) continues:

  “*This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein*”.

Residence of individuals

State A

State B



Residence of individuals

- In many States the residence of individuals is determined under a broad facts-and-circumstances test.
- Under this test, tax authorities of a State decide, based on largely objective facts, whether an individual’s economic and social connections with the country justify taxing the individual as a resident.
- Some States use tests tied to the number of days of presence in that State for determining the residence of individuals.

Residence of individuals

- The OECD MC deals with residence of the individuals in Art. 4(2).
- This paragraph relates to the case where, under the provisions of paragraph 1, an individual is resident of both Contracting States.
- Contracting State may apply different criteria for determining the residence of an individuals and such criteria may be in conflict.

Domestic Criteria for Residence of Individuals

- Physical Presence
- Habitual Abode
- Family Connections
- Residential Property
- Centre of Vital Interests
- Nationality

Physical Presence

- In some States individuals present in a State for 183 days or more in a taxable year are residents for that year.
- Simple majority of the time (e.g. France): not 183 days, but it depends on the State in which the individual has been mostly physically present during the year.
- Substantial presence (e.g. US)

Physical Presence

- The 183-day test is probably enforceable in States that exercise tight control over their borders.
- It is extremely difficult for tax authorities to enforce when many individuals are frequently entering and leaving the State without border checks (e.g. EU member States).
- In most countries the 183-days test cannot operate effectively unless the burden of proof is put on the individual to prove that he/she is not resident for the 183-day period.

Habitual Abode

- “Mental attitude” to stay in a country together with the physical presence
- Usual presence
- It is usually connected to the condition that the individual stays in a country for some years
- In Italian “*dimora abituale*”
- “Habitual” connotes regular and repeated use over a period of time

Family connections and residential properties

- Criteria used in many countries
- Easy if individuals have one family, while complicated if the individuals have more than one family
- Spouse and/or children remain in home location
- Home retained while temporarily absent abroad

Centre of vital interests

- Family and social relations
- Occupation
- Political, cultural and other activities
- Place of busines
- Place from which the individual administers his/her properties
- The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention

Nationality

- In some States nationality is a crucial factor in defining residence and may be problematic when moving abroad.
- E.g. US: nationality creates global liability for world-wide taxation.
- It is extremely difficult for an individual to get rid of his/her nationality.

Country practices for Individuals

France

An individual with a home or principal place of residence in France will be a French tax resident. Home is defined as the place where the taxpayer and his family (spouse and children) normally live. A taxpayer with a spouse and children in France will generally be considered as tax resident even if forced to work abroad for extensive periods of time.

Country Practices for Individuals

USA

- Nationals
- Green Card Holders
- Individuals meeting the Substantial Presence test

Country Practices for Individuals

USA

- Substantial Presence Test

  An expatriate who meets *both* of the following tests is considered a resident of the USA :

  - He is physically present in the US for 31 days in the current year and,
  - He is physically present in the US at least 183 days during the current calendar year and prior 2 years determined by counting each day of presence in the current year as 1 day, each day of presence in the first prior year as one third of a day, and each day of presence in the second prior year as one sixth of a day

Country Practices for Individuals

Ireland

- Two levels of residence – resident and ordinarily resident

- ***Resident*** if in Ireland for more than 183 days in a tax year; or more than 280 days in 2 consecutive tax years, but ignoring any tax year in which he is present for 30 days or less.

- ***Ordinarily resident*** if resident for 3 consecutive years. An individual leaving Ireland will not cease to be ordinarily resident until he has been non-resident for 3 continuous tax years.

Country Practices for Individuals

Belgium

Individuals are regarded as resident in Belgium if they have a permanent home there or if they manage their fortune and economic interests from Belgium. It is a matter of facts and circumstances, not relying on citizenship or the duration of stay

Country Practices for Individuals

Netherlands

Art. 4 General Taxes Act

- “determined by considering the circumstances”
- Concept developed through case law

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

- Why are tie-breaker rules needed?

- Due to differences in domestic residence legislation dual residence is possible. For treaty purposes only one state in which the individual or company is resident

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

"Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement".

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

- Permanent Home
- Centre of Vital Interests (only if a permanent home is available in both States)
- Habitual Abode
- Nationality
- Mutual Agreement

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

Permanent home

Personal and economic relations
(centre of vital interests)

Habitual abode

Nationality

Mutual agreement

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

Permanent Home

- Often sufficient test
- Permanence is a key factor
- Any form of home can fall within the definition
- Should be available (when rented out not available)
- Ownership not required

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

Centre of Vital Interests

- Otherwise known as ‘personal and economic relations’
- ‘Personal’ is a key consideration
- Family and social relations
- Occupations
- Political, cultural and other interests
- Circumstances must be examined as a whole
- ‘First Home’ retention a key concept

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

Habitual Abode

- If a permanent home available in both jurisdictions, staying in one country more than the other generally 'tips the balance'.
- If a permanent home in neither, decided purely on a physical presence basis.
- In any case the residence in the State must be habitual
- Often difficult to determine

Art. 4(2) OECD MC: Tiebreaker Rule for Individuals

Nationality

- Resolves most issues, except, of course, in the case of dual nationals

OECD MC Tiebreaker Rule for Individuals

Mutual Agreement

- Competent Authority
- Procedure outlined in Article 25
- Should apply to the competent authority in the ‘resident’ country (!) within 3 years

Impact of Residence Determination - Individuals

- Dependent Personal Service article
- Independent Personal Service / Business profits article
- Passive Income articles
- Elimination of double taxation

Impact of Residence Determination - Individuals

- Income from Employment (formerly the Dependent Personal Services)
- Key in deciding which jurisdiction has primary taxing rights
- Also an impact on the employer provisions of this article - residence rules need to be considered.

Impact of Residence Determination – Individuals

- Independent Personal Services article
- Deleted from the OECD MC
- Now covered by Business Profits article

Impact of Residence Determination – Individuals

- Passive Income articles
- Dividends & interests: share vs. exclusive taxation
- Royalties: which State has an exclusive taxation right
- Immovable property: primary vs. exclusive taxation
- Capital gains: primary vs. exclusive taxation

Impact of Residence Determination - Individuals

Elimination of Double Taxation (Articles 23A and 23B OECD MC)

- Exemption Method and Credit Method

- Allocates taxing rights – when taxing rights accrue to the Source State, the Residence State must grant relief

Case Study 1

- Pierre is *single* with French nationality.

- He works as a commercial representative in Germany between 1999 and 2002.
- He maintains a home in France
- He rents an Office in Germany
- From 2001, he rents an apartment in Germany for use during the week.

- Where is Pierre resident in the years 1999-2002?

Case Study 1 - Solution

- For 1999 and 2000: French Resident, as he has a permanent home in France
- From 2001, we need to use Article 4 in greater depth:
  - ‘Permanent Home’ in both states
  - Vital Interests arguably evenly divided
  - Place of habitual abode cannot be easily established
  - Nationality is the determining factor

- Therefore, most likely treaty resident of France.

Case Study 2

- Klaas is a 71 years old Dutch national
- He owns a large apartment in Netherlands and a villa in Spain
- He has spent 1 month per year in Netherlands and 11months in Spain
- Klaas has a Spanish temporary residence permit
- His children from a prior marriage live in France; his new wife's children in the Netherlands
- The majority of his assets are in Netherlands; he is a retired managing director of a Dutch company

Case Study 3

- George is a UK national
- He has lived for 10 years in the Netherlands
- He is married to a Dutch woman and has two children
- He worked first in Belgium, then in Luxembourg
- He rented a house in Luxembourg, his family stayed in Netherlands
- He spent the weekends in Netherlands
- Where is George resident?

Case Study 4

- Wilhelm is a German national
- He was MD and owner of a German company
- He married a Danish woman in 1991
- Wilhelm moved to to Denmark in 1994
- He commuted to Germany daily, occasionally he was staying over at his workplace

- Where is Wilhelm resident?