The OECD Model Convention
Part 3

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Lesson 06

Programme of the Day 06

- Addressing *Passive* income as compared to *Active*;
- Discovering the similarities and differences between interests, dividends and royalties (and *capital gains … but not today*);
- The mechanics of withholding taxation;
- The definition of “Beneficial owner” of Income;
    - The necessity to address aggressive tax planning and conduit companies.

What is “Passive” Income ?

- Articles 10, 11, 12 and 13 of the Model Convention: Dividends, Interests, Royalties and Capital gains;
  - Passive because they are earned virtually “*doing nothing*” (inaccurate !);
- See definition on the Model Convention Texts;
- Common background:
  - <u>Priority to the Residence state</u>;
  - Possibility to apply a <u>Withholding Tax at Source</u> (on some occasions);
  - Tax credited in the Residence State according to the Tax Credit system;
  - Necessity to rely on the interpretation of the Treaty (no remedy for the conflict of qualification).

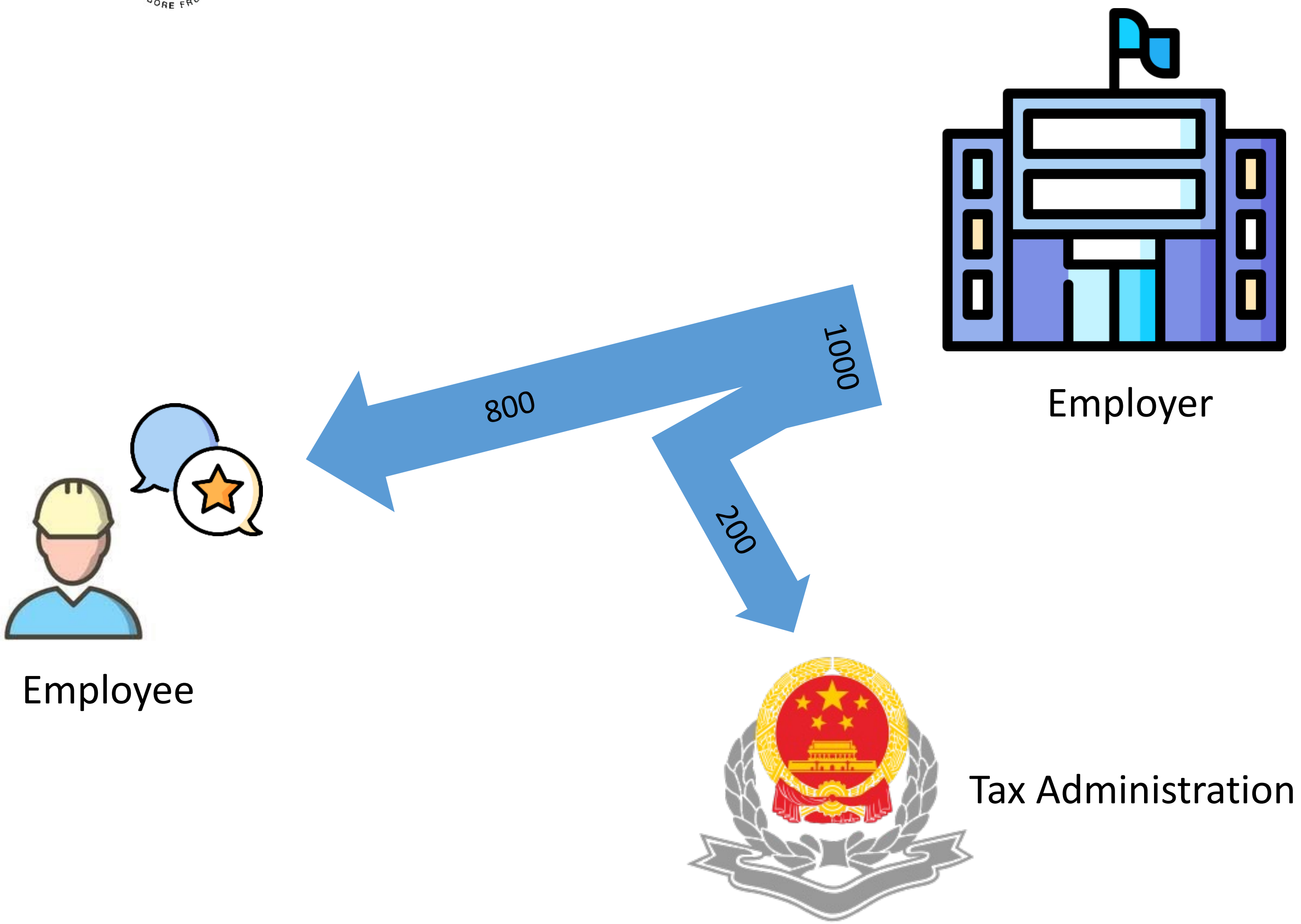
But Before that …
What's Withholding Tax ?

- It's a specific form of taxation at source, charged on a qualified item of income;
  - Conditions to the application of it depend on national law of the case
- It occurs in man contexts:
  - Domestic (mostly labour income)
  - International (mostly passive income)
- Reason:
  - Contrast tax evasion, anticipation of the tax payment, claw back of the taxing power.

Legal Features

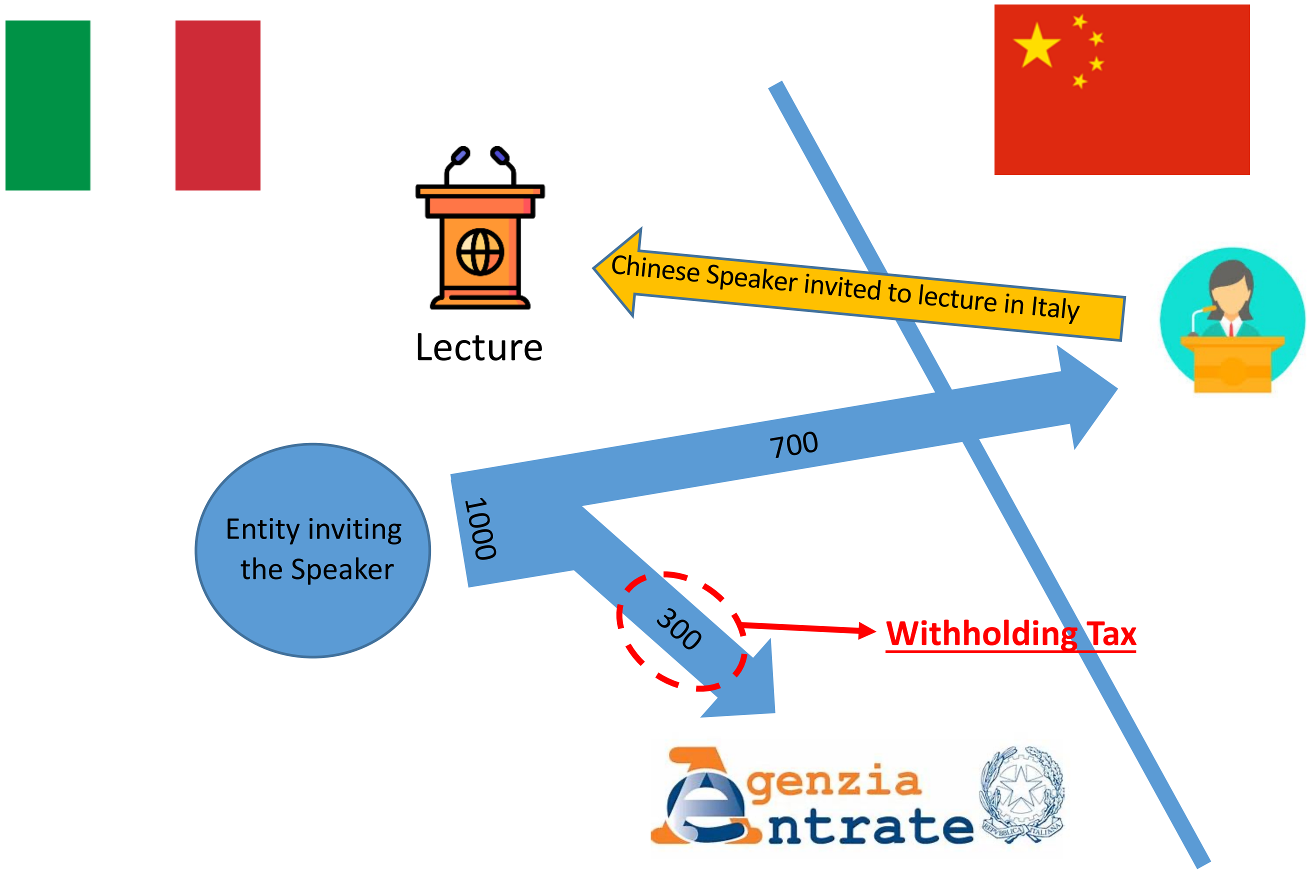
- Preliminary remarks: all depends on the national provisions, the current analysis is therefore a general survey of the standard features of the system;
- Withholding taxation is mostly a system of taxation emphasising the <u>real</u> features of a tax, to the detriment of <u>personal</u> ones;
  - Personal tax: tax charged on persons considering their specific ability to pay (family status, situation, etc).
    - Mostly progressive.
  - Real tax: tax charged on an item of income irrespective of the situation of the owner;
    - Mostly proportional.

Withholding Taxation in the Domestic Scenario



1. The employee is «charged» at source;
2. The preliminary payment to the Tax Administration is made by the employer.
3. The amount paid is deducted from the salary;
4. Depending on the cases, the employer might be subject to further taxation on the very same income as to preserve the progressivity of the system.

Withholding Taxation in International Taxation: Real Life Scenario



Going back to OECD Model: Dividend Taxation

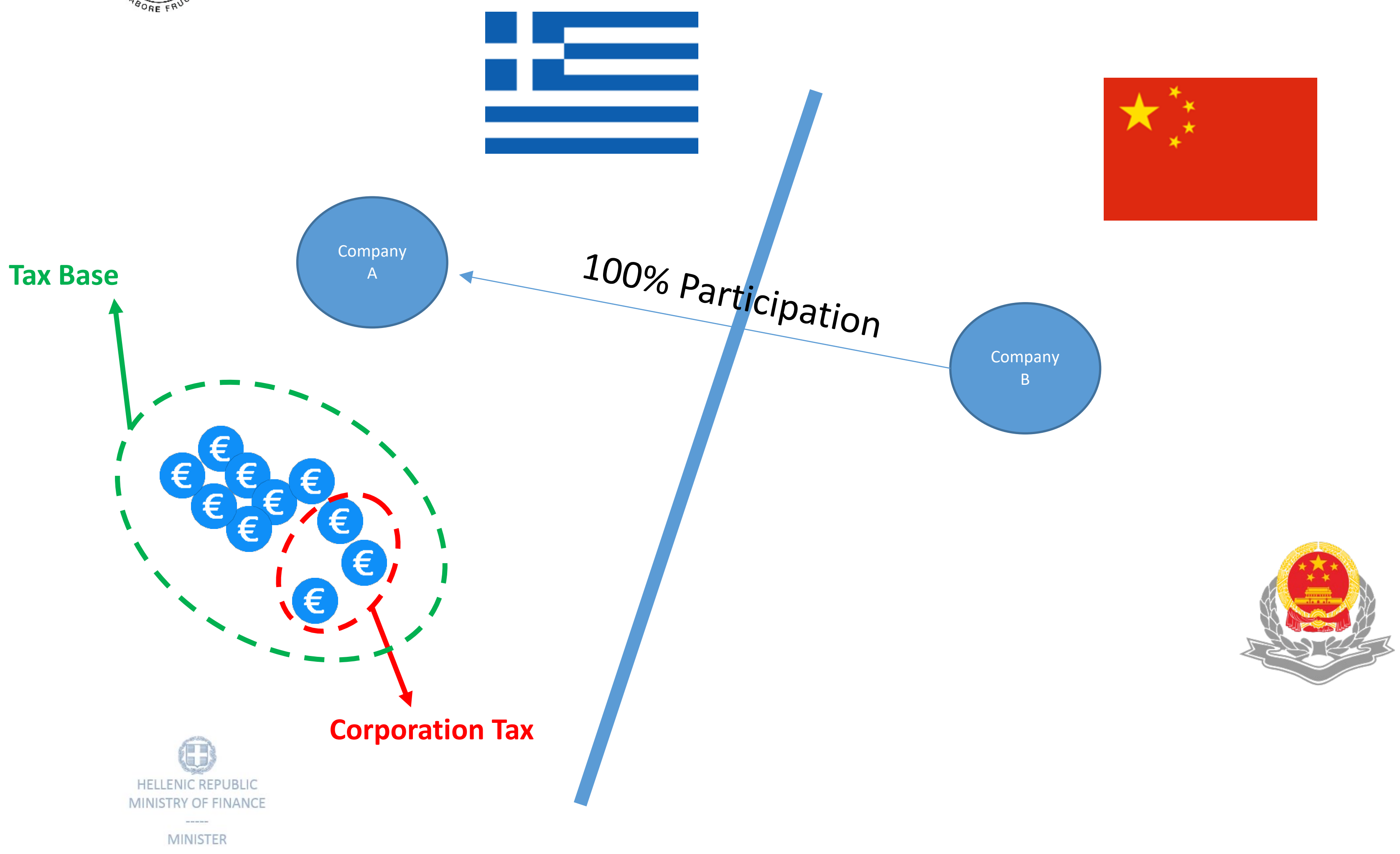
- Dividends paid by a company which is a resident of a State to a resident of the other State may be taxed in that other State;
- However, dividends paid by a company which is a resident of a State may also be taxed in that State according to the laws of that State, but **<u>if the beneficial owner</u>** of the dividends is a resident of the other State, the tax so charged shall not exceed specific amounts.

<u>Withholding Tax</u>

Limits to Withholding Taxation

- Limiting withholding taxation:
  a) 5% of the amount of the dividends if the beneficial owner is a company which holds directly at least 25% of the capital of the company paying the dividends throughout a 365 day period (…);
  b) 15% of the gross amount of the dividends in all other cases.
- Why is this difference ?
  - Promote stability in investments.
- Alas, the scenario might be more complicated …

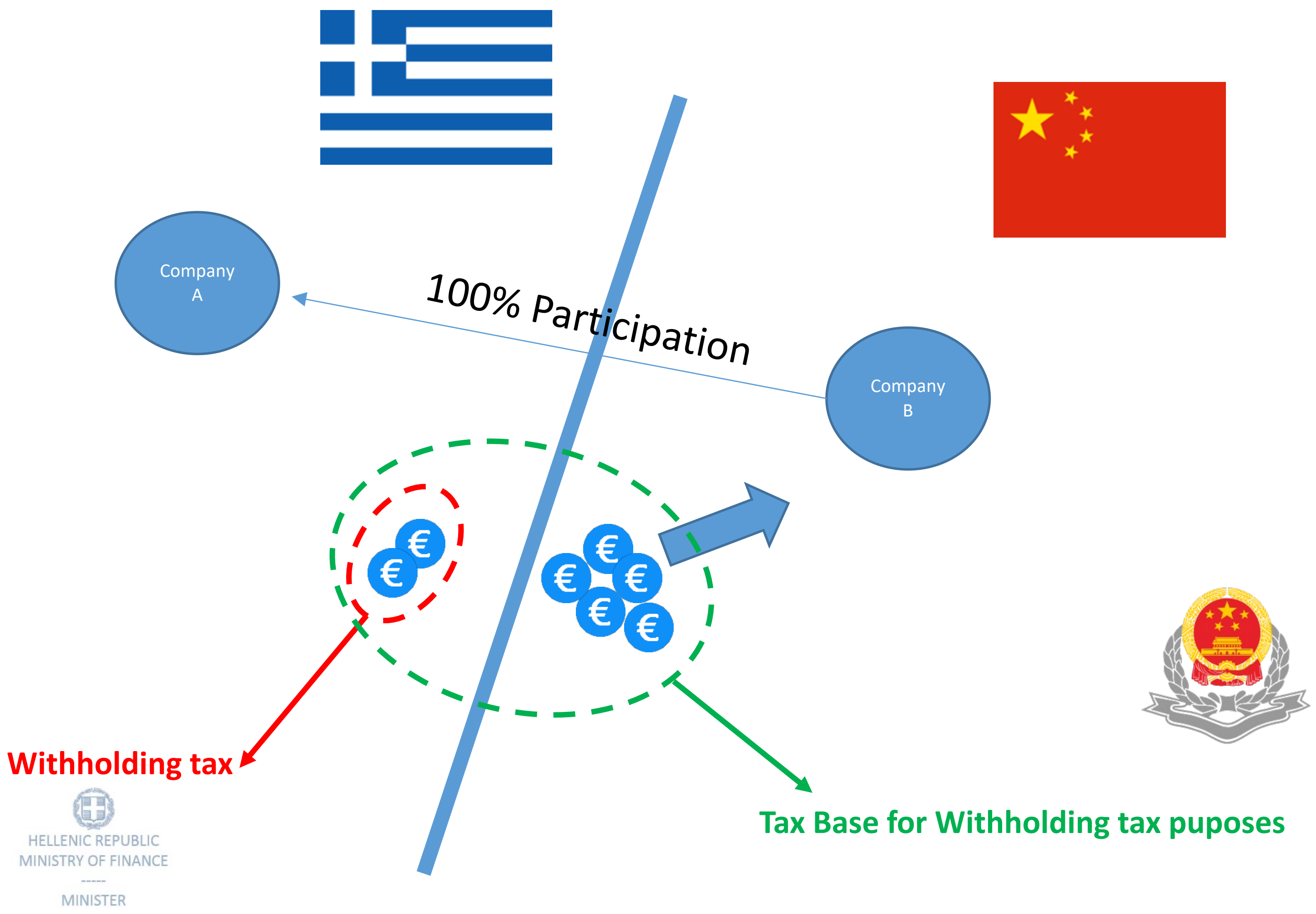
How Taxation is Deployed in Cross-Border Cases …



- Phase 1:
  1. Income of company A is taxed in Greece as business income.
  2. Payment is made to the local tax administration;
  3. A decides to distribute dividends to shareholders.

Warning! Fictitious example. Real life scenario might be different. See slide 13.

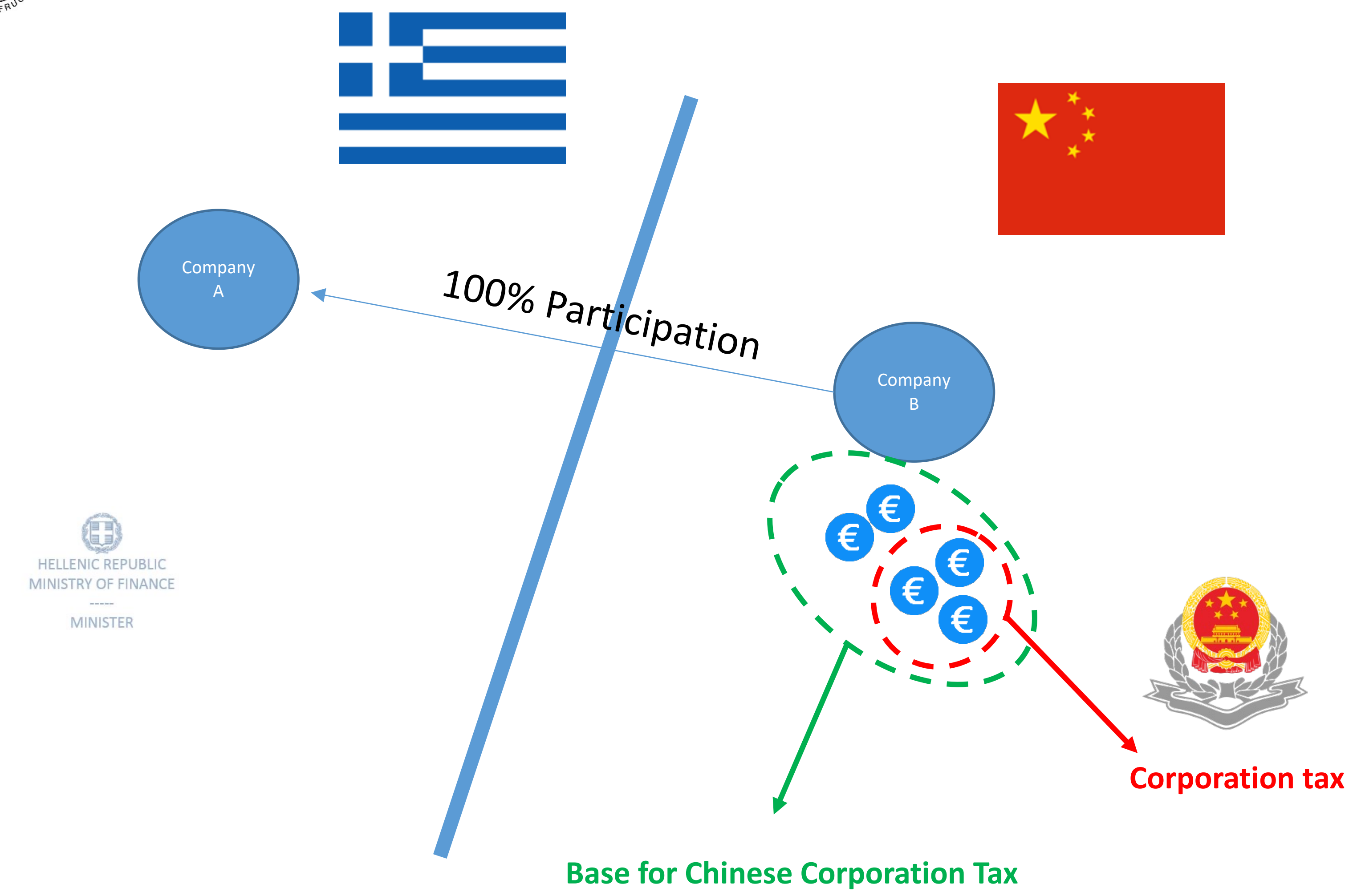
Continued …



- Phase 2:
  1. A Withholding tax is charged on dividends and paid to the Greek tax administration;
  2. The tax actually “hit” the parent company as it receives less money;
  3. In this moment, a DTC might reduce the amount of it.

Warning! Fictitious example. Real life scenario might be different. See slide 13.

Continued …



- Phase 3:
    1. Money is received by Company B (the Parent company);
    2. As it is new money, it becomes Company B’s income and it is taxed;
    3. Chinese corporation tax might be applicable.

Warning! Fictitious example. Real life scenario might be different. See slide 13.

Disclaimer

- The case presented is the "Nightmare scenario" when all goes wrong, natural remedies might be:
  - Source states unilaterally waives withholding taxation in many cases (such as the Netherlands is doing);
  - The residence state does not charge a tax on the profits received by the subsidiary …
    - This might open the floor to double non taxation if business profits are not taxed in the source state either;
    - Normally the Tax administration addresses such situations.
  - National flags were used for descriptive purposes only, actual legislation in Greece / China might be different.

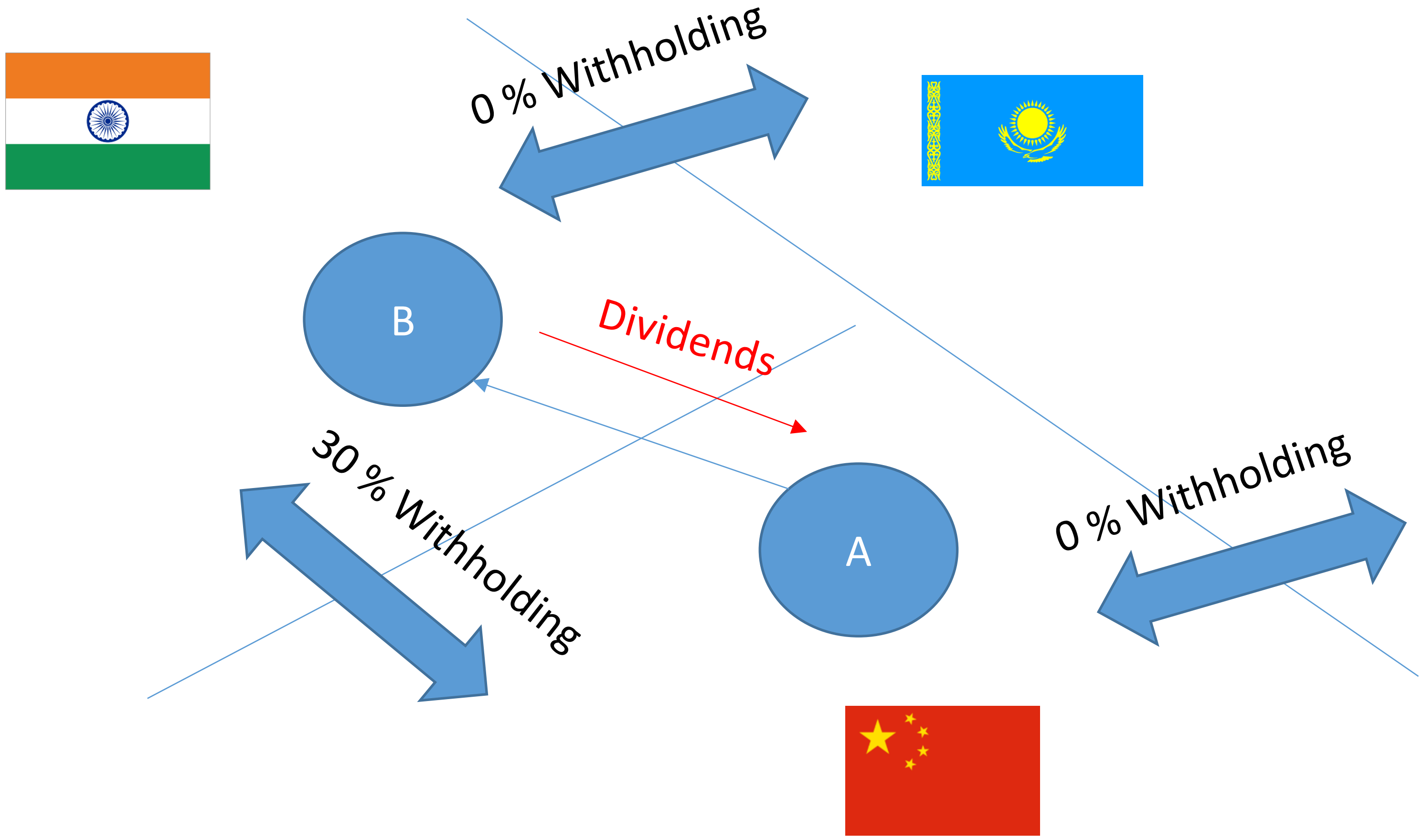
Introducing the Beneficial Owner

- We have already seen this slide: Article 10 OECD Model (§§1 and 2)
  - Dividends paid by a company which is a resident of a State to a resident of the other State may be taxed in that other State;
  - However, dividends paid by a company which is a resident of a State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other State, the tax so charged shall not exceed specific amounts.

The Purpose and the Limits to the Provision

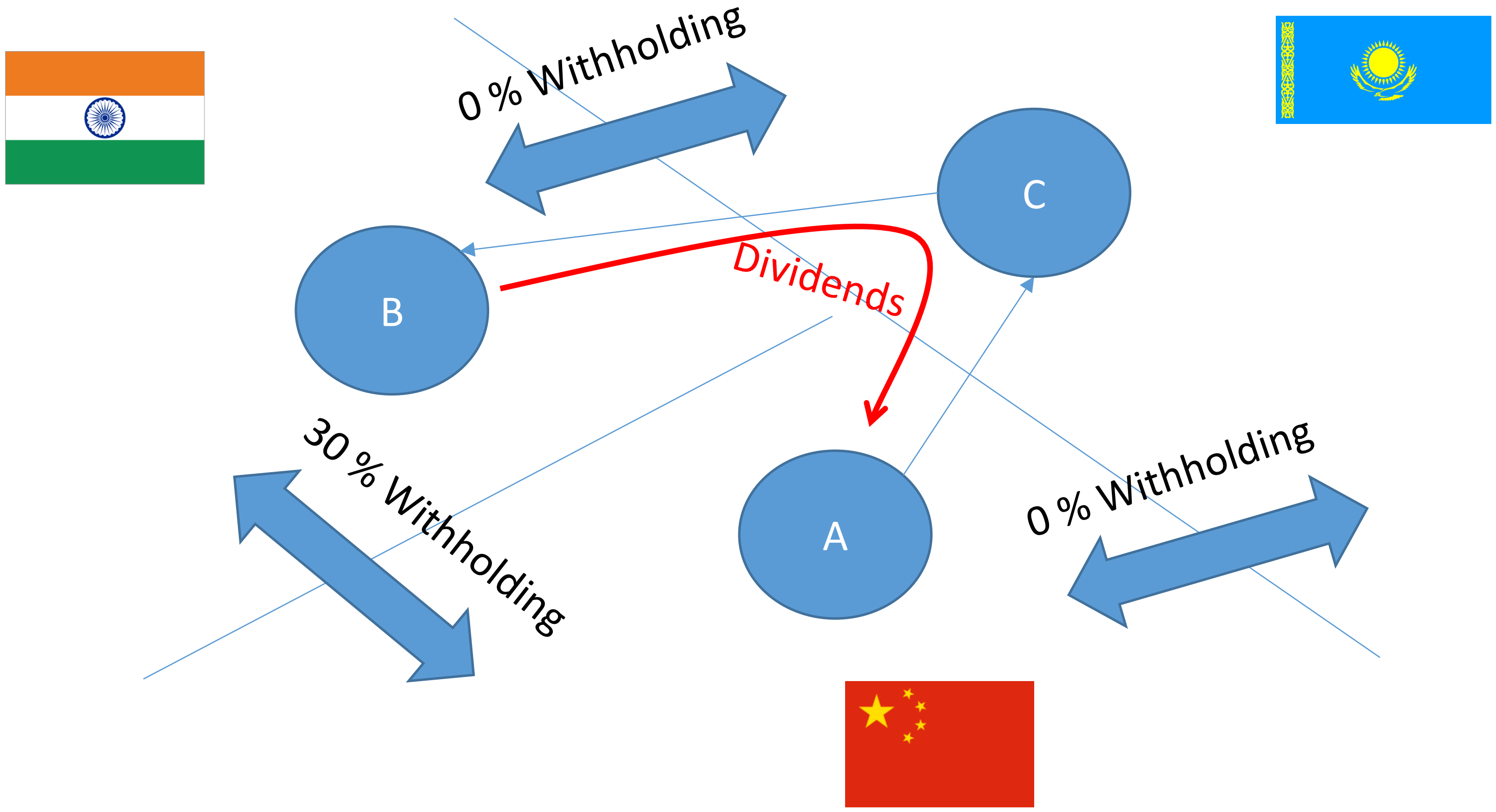
- Anti-Avoidance Provision inserted in the Treaties to prevent abusive behaviour by the taxpayer;
- Beneficial Ownership to contrast:
    1. Shell Companies;
    2. Step- Stone companies;
    3. …
- Difficult to set a limit to the concept of “ownership”:
    - Common law;
    - Civil law system.

Aggressive Tax Planning: a Case



Fictitious case: rates and treaties might be different.

A Possible Tax planning Strategy ?



Fictitious case: rates and treaties might be different.

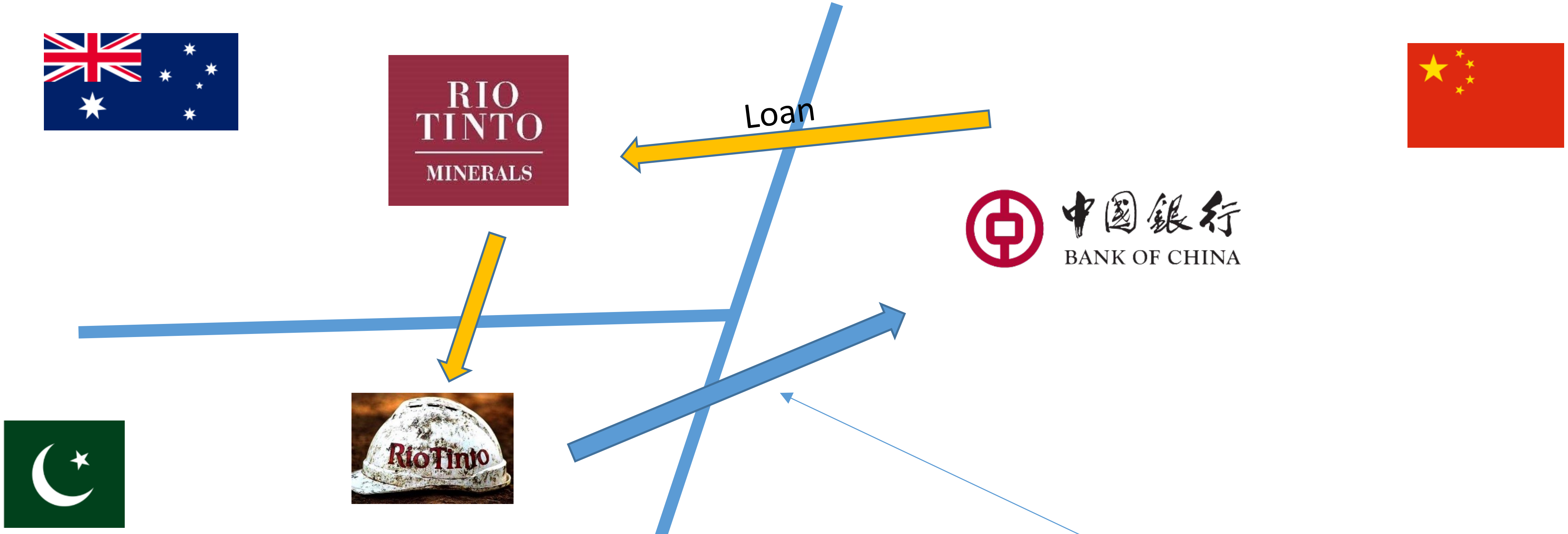
Is C a "Beneficial Owner" of Dividends ?

- Final Answer depends on a number of benchmarks including:
  1. **Amount** of the participation of A in C;
  2. **Actual** activity of company C besides the distribution of dividends;
  3. **Duration** of the participation and amount of dividends channelled;
  4. **Statutory** regulations of the case applicable to company C;
  5. **Identity** of the Managers (Interlocked Directorate);
  6. **Other** evidence;
  7. …

Interests Taxation in the Model Convention (Article 11)

- Interest arising in a State and paid to a resident of the other State may be taxed in that other State;
- However, interest arising in a State may also be taxed in that State according to the laws of that State, but if the **beneficial owner** of the interest is a resident of the other State, the tax so charged <u>shall not exceed</u> 10% of the interest.
- Interest shall be deemed to arise in a State when the payer is a resident of that State.
  - Where the person paying the interest, whether he is a resident of the State or not, has in a third State a permanent establishment in connection with which the indebtedness was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

Another case …



Permanent establishment

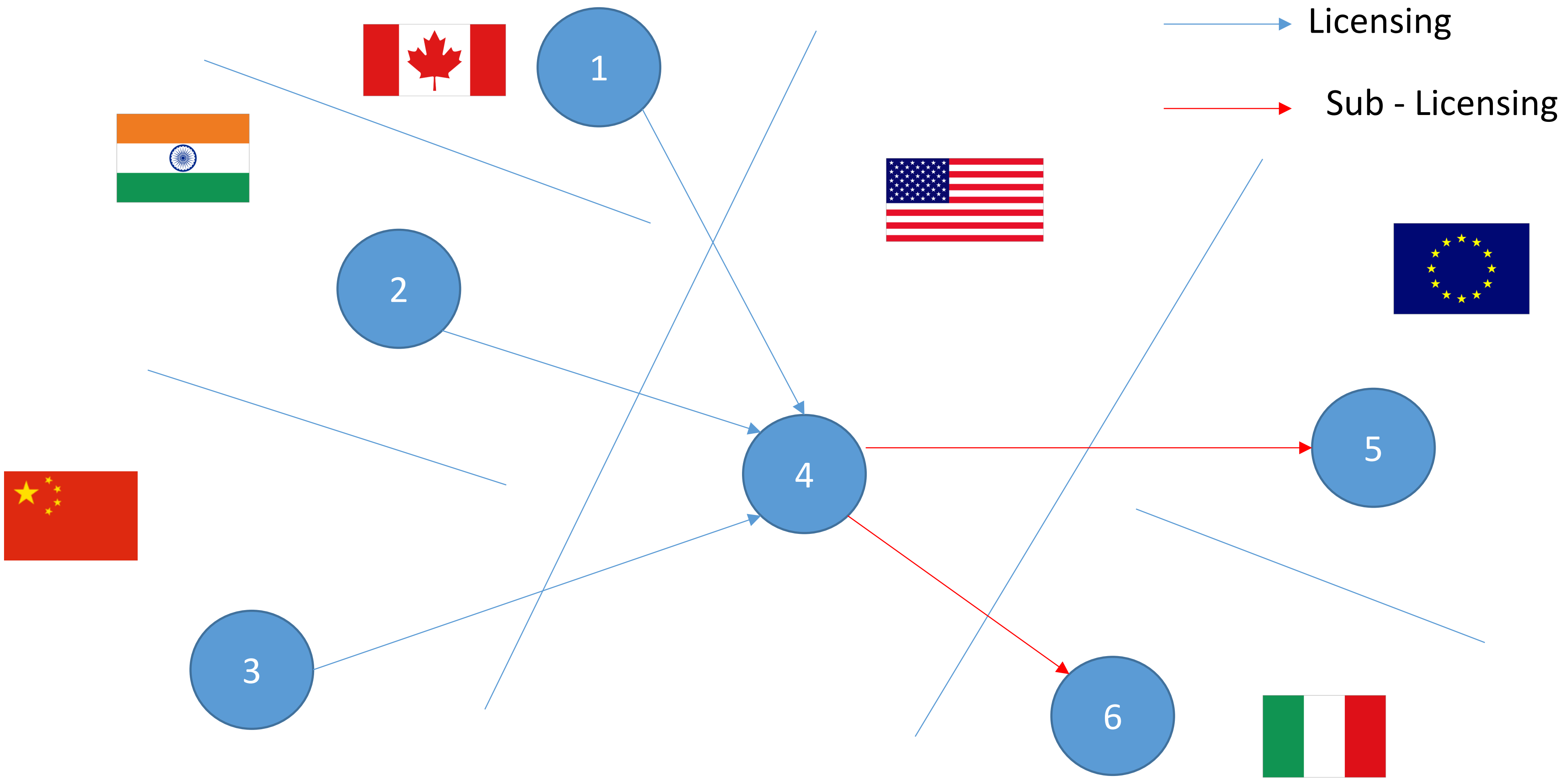
Source country is Pakistan if Rio Tinto uses the loan to the interest of the PE there.

Fictitious case: rates and treaties might be different.

Royalties Taxation in the Model Convention (Article 12)

- Royalties arising in a State and **beneficially owned** by a resident of the other State shall be taxable only in that other State;
- The term "Royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, 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.

More complex Cases: License Pooling



Question on the Ground

- Company 4 might not be considered the beneficial owner of the royalties as it enjoys a sub license from other companies;
- Dangerous situation for the investor as he could lose the benefit of the Treaty (if any);
- Necessity to be <u>very careful</u> in writing the contracts.

End of Lesson 06

- Suggested readings (B, elective): Greggi Marco, *Limitation on Benefit Clauses in International Tax law,* Ferrara, 2014.