The OECD Model Convention Part 1 (Residence)

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Academic Year 2023 - 2024

Lesson 04

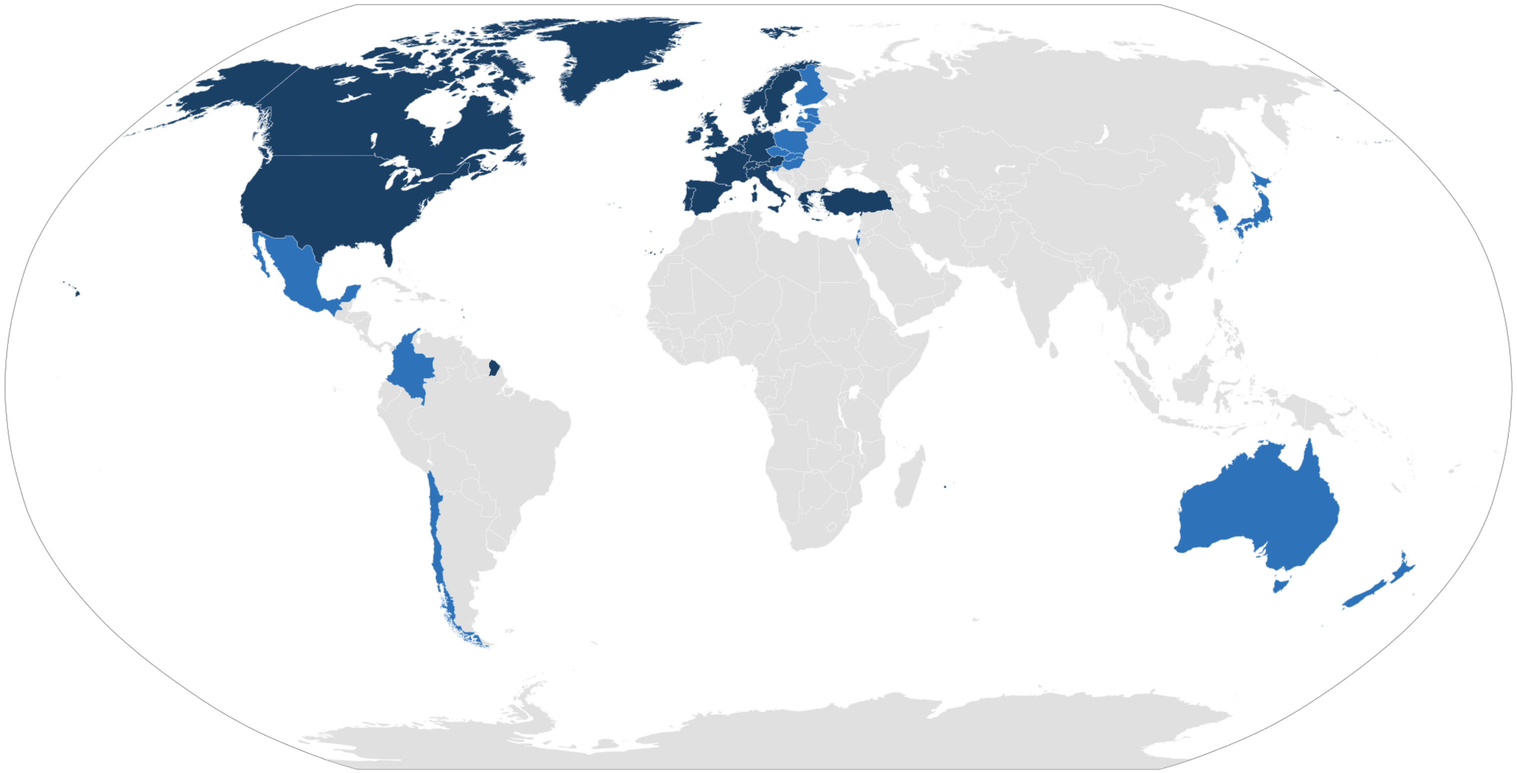
Programme of the Day 04

- General introduction to the OECD (history, policies, impact on Kazakhstan);
- The Model Tax Convention;
  - The scope;
  - The taxes covered;
  - Interpretive guidelines beyond the Vienna convention;
- Residence for Tax purposes (Article 4);
- The Permanent establishment (Article 5): some notions.

Organisation for Economic Co-operation and Development

- OECD is an **intergovernmental** economic organisation founded in 1961 to stimulate economic progress and world trade;
- Forum of countries committed to democracy and the **market economy**. It compares policy experiences, seeking answers to problems, good practices and coordinate domestic and international policies;
- Generally, OECD members are **high-income economies**;
- OECD does not have a power to enforce its decisions, it is recognized as highly influential publisher of mostly economic data through publications as well as annual evaluations and rankings of members countries.

The OECD Geography



Founding member countries (1961) - Other member countries

The History of the Organisation

1. The Organisation for European Economic Co-operation (OEEC) was incorporated in 1948 to administer American and Canadian aid in the framework of the Marshall Plan for the reconstruction of Europe after World War II;
2. After the Marshall Plan ended, the OEEC focused on economic issues;
3. In the 1950s, the OEEC provided the framework for negotiations for setting up a European Free Trade Area, to bring the European Economic Community and the other OEEC members together on a multilateral basis;
4. In late 1950s, with the job of rebuilding Europe effectively done, some leading countries felt that the OEEC had outlived its purpose, but could be adapted to fulfill a more global mission.
5. **In January 1960, a resolution was reached to create a body that would deal not only with European and Atlantic economic issues, but devise policies to assist less developed countries.**

… and the Influence on Taxation

- The OECD develops a **Model Tax Convention** that is a template for allocating taxation rights between countries:
    1. The model is doubled with **commentaries** reflecting OECD interpretation of the content of the Model;
    2. The model allocates the **primary right** to tax to the country from which capital investment originates (the home / resident country) rather than the country in which the investment is made (the host / source country).
    3. As a result, it is most effective as between **two countries with reciprocal investment flows** (as among OECD member countries), but is unbalanced when one of the two is economically weaker than the other.
- The OECD publishes the <u>Transfer Pricing Guidelines</u> since the late seventies.
    - The Transfer Pricing Guidelines serve as a template for profit allocation of intercompany transactions to countries (Lessons 6 and 7);
- In 2013 it started the **Base Erosion and Profit Shifting** (BEPS) project upon request by the G20.

Approaching the OECD Model Treaty

The Tax Treaty

- Part 1 (Artt. 1 – 2)
  Taxes and Persons covered
- Part 2 (Articles 3 – 5)
  General definitions as to the application of the Treaty
- Part 3 (Articles 6 – 21)
  Income Taxation
- Part 4 (Article 22)
  Taxation of Capital
- Part 5 (Articles 23A and 23B)
  Elimination of Double taxation (Methods)
- Part 6 (Articles 24 – 30)
  Special provisions
- Part 7 (Articles 31 and 32)
  Concluding provisions

Article 1: Persons Covered

- The Convention is applicable to persons who are residents of one or both of the Contracting States;
- The Convention does not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted is specific chapters;
  - The scope of the treaty is limited to cross-border scenarios.

Article 2: Taxes Covered

- This Convention shall apply to taxes on income and on capital imposed on behalf of a State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
  - There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains …;
- The Convention shall apply also to any **identical or substantially similar taxes that are imposed after the date** of signature of the Convention.

More to the Point

- Models (OECD one is no exception) cover taxes on income and on capital;
  - In practice taxes on capital are not often considered;
  - Income taxes: <u>name</u> is not relevant since they may change from time to time (comparability test);
  - Income taxes: <u>political subdivision</u> is not relevant (both national or local taxes – on income – are considered;
- <u>Key point</u>: not always easy to assess the nature of a payment as a "Tax" (in the Kazakh situations, maybe, some local charges are qualified "contributes" or "prices" but are taxes in disguise ?).

Article 3: General Definitions

- In the Convention, unless the context otherwise requires:
- *… omissis …*
- As regards the application of the Convention by a **State any term not defined therein** shall, unless the context otherwise requires, have the meaning which it has **under the laws of that State** concerning the taxes to which the Convention applies.
  - Domestic law is therefore **essential** in the interpretation of the Treaties.

Article 4: Residence

- For the purposes of the Convention, the term “Resident of a Contracting State” means any person who, under the law of that State, is **liable to taxation therein** by reason of his **domicile**, **residence**, **place of management** or **any criterion** of a similar nature.
  - ... But this term does not include any person who is liable to tax in that Contracting State in respect only of income from sources in that State or capital situated therein.
  - Tie break rules: (1) Permanent home; (2) Center of vital interests, (3) Habitual abode, (4) Nationality, (5) Mutual agreement by the two tax administration.

The case for Corporations

- Most of the Countries (all the OECD ones) tax according to several criteria:
  - Legal Seat of the Company;
    - The place under which legislation the company has been incorporated and <u>where it is deemed to be resident according to the act of incorporation / statute</u>;
  - **Place of Effective Management**;
    - The place where the key decision of the business are actually taken;
- Some of the Countries also add:
  - Place where the <u>Main Business</u> is carried on;
    - The place where the most relevant factory is located, for instance.

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The FIAT / FCA Case

Before 2014

FIAT

Now

FCA FIAT CHRYSLER AUTOMOBILES

Place of effective management

FCA FIAT CHRYSLER AUTOMOBILES

Legal seat

FCA FIAT CHRYSLER AUTOMOBILES

Main business (?)

Understanding the Tax Planning

Sergio Marchionne (1952 – 2018)

- Sergio Marchionne's strategy: "*Take the best from the North and the South*":
    - UK: low taxation on profits;
    - Netherlands: better corporate governance rules;
    - Italy: exploitation of the current factories and skilled workforce.

Evaluating the Decision

- Balancing *pros* and *cons* of the operation;
- Pros:
  1. Less taxes, more profits;
  2. Improved governance of the corporation;
  3. More reliable legal system;
- Cons:
  1. Exposure to potential double taxation;
  2. Risk to jeopardize all the advantages gained;
- Need for a remedy.

Place of Effective Management (till 2017)

- Prevailing criterion in International Taxation:
- A Company is deemed to be resident in the Country where its Place of effective management (PoEM) is located;
  - It’s a “Tie break rule” aimed at minimizing the risks of double taxation;
- Consequence: only that Country (where the PoEM is situated) may consider the Company of the case resident for tax purposes.
  - This does not resolve all the problems, anyway …

Current Situation (Article 4, § 3)

- Where by reason of the provisions of § 1 a person other than an individual is a resident of both Contracting States, **the competent authorities of the Contracting States shall endeavour to determine by mutual agreement** the State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to:
    1. Its place of effective management,
    2. The place where it is incorporated or otherwise constituted and
    3. Any other relevant factors.
- ...

Introducing the Permanent Establishment

- What if a company is resident in one state but does business in another one … maybe with a smaller branch ?

Huawei flagship store in Milan, allegedly the first in Europe

The Huawei Case (*Fictitious*)

Profits:
Shop: 100000 Tenge
HQ: 10.000 Yuan

End of Lesson 04

- Suggested readings (B, elective): C. H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, Columbia Journal of Tax Law, 2013, 5(1)pages 1 – 39.