INTERNATIONAL DOUBLE TAXATION

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Preface

This book is an updated expansion of the compendium which for several years has been used for teaching and lecturing in Denmark as well as abroad.

The contents are mainly based on the OECD Model Convention and its commentaries. Furthermore, the description of 'partnerships' is to a great extent based on extracts from the report 'The Application of the OECD Model Tax Convention to Partnerships'.

The purpose of the book is partly to form the basis of instruction on international double taxation at different levels and partly to give guidance to persons dealing with these matters in practice.

Emphasis is laid on the provisions which allocate the taxation right to different categories of income between two countries with a tax agreement. The remaining provisions, for example the provisions concerning transfer pricing, non-discrimination, mutual agreement procedure, exchange of information, etc. are only dealt with briefly.

Various 'triangular cases' are dealt with although these might be rare in practice. The reason for including these cases is partly that they are important in order to understand the theoretical structure of the Model Convention and partly to enable the practitioner to handle this, often complicated, issue correctly.

A number of examples from the commentaries, from Danish administrative practice and from court decisions are also given. However, there is nothing 'particularly Danish' in the examples. The situations that are described may occur between any countries.

Further the book contains a description of the most important points where the United Nations Model Double Taxation Convention (the UN Model Convention) deviates from the OECD Model Convention and a description of a number of provisions that can occur in Conventions but are not found in the Models.

Finally, a rather detailed description is given of the changes in the Commentary in connection with the 2010-update of the Model Convention.

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Chapter 1
Introduction

§ 1.01 DEFINITION OF A DOUBLE TAXATION CONVENTION

A Double Taxation Convention (hereinafter 'convention') is an agreement which is concluded between two States in order to prevent a person who is fully liable to tax in one of the States (or sometimes in both States) from being taxed on the same income (or capital) in both States.

§ 1.02 JURIDICAL DOUBLE TAXATION

The fact that two States (in certain cases, more than two States) tax the same taxpayer on the same income (or capital) is called juridical double taxation.

§ 1.03 WHY DOES DOUBLE TAXATION OCCUR?

Double taxation occurs because most States tax their residents (both individuals and companies) on the total annual income irrespective of whether the income derives from their country of residence or from abroad (full tax liability). Besides taxing persons who are fully liable to tax, States also tax persons who are not fully liable to tax on different kinds of activities performed in the territory of the State (limited tax liability).

Example 1

A person who is a resident of Denmark and accordingly subject to full tax liability there works in Norway for four months for a Norwegian employer.

The income from Norway is included in the Danish tax return. However, the income from Norway is also taxed in Norway in accordance with the national Norwegian tax rules on the taxation of persons who are subject to limited tax liability.

Example 2

Dividend from a Danish company is subject to a withholding tax of 28%. If the shareholder is an individual resident in Russia, the dividend is also taxed in Russia since the dividend is included in the total income of the shareholder.

§ 1.04 ECONOMIC DOUBLE TAXATION

In addition to the above-mentioned juridical double taxation, *economic* double taxation occurs when two different persons are taxable in respect of the same income or capital. Economic double taxation is *not* covered by the convention (see, however, paragraph 2 of Article 9 of the Model Tax Convention on Income and on Capital (hereinafter the Model Convention) published by Organisation for Economic Co-operation and Development (OECD)). This provision is briefly described in the section Article 9: Associated Enterprises.

Example

A, a resident of Denmark, complained that the tax authorities had refused to allow him to deduct alimony to his wife and children who lived in the Netherlands. The wife and the children were taxed in the Netherlands on the alimony. The deduction was refused by the Danish tax authorities on the grounds that the alimony had not been approved by the Danish authorities.

A argued that the refusal of the deduction resulted in an economic double taxation that was contrary to Article 25 (Mutual agreement procedure) in the convention between Denmark and the Netherlands. According to this article, a person who considers that the action of a Contracting State results in a taxation which is not in accordance with the convention may present the case to the competent authority of the Contracting State of which he is a resident. The competent authority must endeavour to solve the question if necessary by a mutual agreement with the other State.

However, the National Income Tax Tribunal did not change the decision of the local authority and stated that Article 25 of the convention did not apply since no double taxation had occurred within the meaning of the convention. Because of this fact there was no reason to contact the foreign tax authority.

§ 1.05 THE LEGAL STATUS OF THE DANISH CONVENTIONS

Denmark has concluded more than seventy conventions with foreign States; and from 1994 the conventions have to be adopted by the Danish parliament, by law.

Before 1994 the Government was authorized, subject to reciprocity, to permit such *relief* in the duty to pay taxes that double taxation would be wholly or partly avoided.

The word 'relief' is very important. The conventions can only eliminate (relieve) a tax. A convention which Denmark has concluded with a foreign State therefore implies that the Danish tax rules are suspended to the extent necessary to respect the convention.

This means that a convention cannot make taxation more burdensome or, in other words, a convention cannot introduce a taxation which is not contained in the existing tax legislation.

According to the preparatory works of the Act of 1994, this is still the situation.

Example

According to Article 11 of the convention, Denmark is entitled to tax interest paid to a person resident in the other State at 10%. A person who is a resident of the other State receives interest from Danish bonds. Since Denmark, according to its national legislation, is not entitled to tax interest paid to non-residents, Denmark cannot make use of the taxation right in Article 11.

§ 1.06 THE MODEL CONVENTION

The number of conventions worldwide is very considerable. Most of the conventions are based on the Model Convention. In order to be able to work with a convention it is important to be familiar with the systematization and structure of the Model Convention.

However, no conventions correspond wholly to the recommendations in the Model Convention.

For this reason, when dealing with specific cases, it is always necessary to read the relevant articles in the convention in question and be aware that a protocol is attached to most of the conventions. This protocol sometimes contains important rules, which supplement the text of the articles. Examples of protocol provisions are given in section § 4.01 Technical Fees.

§ 1.07 SURVEY OF THE SYSTEMATIZATION OF THE MODEL CONVENTION

[A] Brief Overview of the Model Convention

The Model Convention consists of thirty-one articles.

Articles 1–5 and 9 lay down and define some fundamental concepts. Article 4 defines in which of the two States a person is considered to be a resident for purposes of the convention is applied.

Articles 6–8 and 10–22 establish in which of the States different kinds of income (and capital) may be taxed.

Article 23 A and B establishes how the double taxation must be eliminated.

Articles 24–31 contain special provisions which, only indirectly, have to do with the right to tax the different kinds of income.

[B] The Technique Behind Elimination of Double Taxation

In order for a convention to be applied, one State must be nominated as the State of residence. Therefore, the first step is to determine which State must be considered to be the State of residence of the taxpayer. This determination is made by using the provisions of Article 4. The State of residence, and only this State, has the right to tax the person on his worldwide income and this right is not limited by the convention.

The other State is classified as the State of source, and this State may tax income which it is entitled to tax according to several articles (Articles 6, 7, 10, 11, paragraphs 1, 2 and 4 of Article 13, paragraph 1 of Article 15, 16, 17, 19 and paragraph 2 of Article 21). In these articles the wording *may be taxed* is used (except in Article 19 where the wording 'shall be taxable only' is used).

Regarding other articles (Articles 8, 12, paragraph 5 of Article 13, paragraph 2 of Article 15, 18 and paragraph 1 of Article 21), an exclusive taxation right is given to the State of residence. Accordingly, when income is attributable to one of these articles no double taxation occurs. In these articles the wording *shall be taxable only* is used.

[C] Elimination of Double Taxation

Article 23 A and B provides how double taxation must be eliminated. It is *always the State of residence* (the State which is given a primary right to tax the whole income) which must eliminate the double taxation.

Double taxation is eliminated by using either the *credit method* or the *exemption method.*

The *credit method* is applied by a great number of States, one State among which is Denmark. According to this method, the State of residence must, when income may be taxed in the other State (the source State), allow the tax paid in the State of source to be deducted from the tax on the income levied in the State of residence. However, the deduction may not exceed that part of the income tax, which is attributable to the income which may be taxed in the State of source. In other words, if the tax in the source State is lower than the tax in the State of residence, deduction must be allowed for the tax paid in the source State. If the tax in the source State is higher than the tax in the State of residence, the State of residence is not obliged to allow deduction for the excess amount.

When the *exemption method* is applied, the State of residence is always obliged to exempt the income from the source State from taxation, regardless of the amount of the foreign tax.

The credit method and the exemption method are described in section § 2.23 Article 23: Methods for Elimination of Double Taxation.

A typical example of a double taxation situation was given in section § 1.03 Why Does Double Taxation Occur?:

> A person who is a resident of Denmark and accordingly subject to full tax liability there works in Norway four months for a Norwegian employer. The income from Norway is included in the Danish tax return. However, the income from Norway is also taxed in Norway in accordance with the national Norwegian tax rules on taxation of persons who are subject to limited tax liability.

When solving this case the first step is, as already mentioned, to determine the State of residence of the person in question. According to Article 4, the first test is to see in which State the person has a permanent home available. During his stay in Norway the person lived in a rented room and in the present case there is no doubt that Denmark must be regarded as the State of residence. In accordance with paragraph 1 of Article 15, Norway has the right to tax the income earned in Norway. Denmark must hereafter give credit for the Norwegian tax. The final result is that the person pays the same tax as if the total income was earned in Denmark; (since the Norwegian tax is lower than the Danish tax, the total amount of Norwegian tax is deducted from the Danish tax).

§ 1.08 SUMMARY OF THE ARTICLES IN THE MODEL CONVENTION

In the following, substantive aspects of some of the individual articles will be described. It is important to compare these brief descriptions with the full contents of the individual articles in order to be familiar with the language of the convention. After this summary, the articles will be described in detail and a number of examples will be given.

Article 1 applies to persons who are residents of one or both of the two States. The term 'resident' is defined in Article 4.

According to *Article 2,* the convention applies to taxes on income and capital. Each State enumerates the taxes that the State wants to be covered by the convention.

Article 3 contains definitions of a number of terms used in the Model Convention. It should be noted that the term 'person' includes both individuals and legal persons.

Article 4 'Resident' is a crucial provision. In order to apply the convention, only one State may be appointed as the State of residence that is the State which is entitled to tax the person on his worldwide income.

As regards *individuals,* it follows from paragraph 2 that the individual may be deemed to be a resident only of the State in which he has a permanent home available to him. As regards *other persons than an individual* (a company and other legal entity), it follows from paragraph 3 that such person may be deemed to be a resident only of the State where it has its place of effective management.

In most cases it is evident which State is the State of residence, but sometimes a person is considered to be subject to full tax liability in more than one State according to the national legislation of these States. Article 4 contains rules for solving the conflict which arises when more than one State subjects the same person to tax on his worldwide income. Such a conflict arises, for example, in cases where an individual has a permanent home available to him in either the States or where a company is registered in one State and has its place of effective management in the other State. When it is settled which State is considered to be the State of residence, the other State is automatically classified as the State of source.

According to paragraph 1 of *Article 5*, a Permanent Establishment (PE) means a fixed place of business through which the business of an enterprise is wholly or partly carried on. It is emphasized that the activity in question, which an enterprise performs in the other State, is *not* performed through a company or a similar legal entity. If this were the case, the activities would be performed by a person who is fully liable to taxation in the State in question; this is not the case for a PE which is subject to limited tax liability.

Examples of a PE are as follows: a branch, an office, a shop, a building or construction site, etc. In principle, all kinds of activities performed in a country to achieve a profit may constitute a PE. In this connection it must be mentioned that banks and insurance companies normally operate abroad through branches.

According to paragraph 3 of the article, a building site constitutes a PE only if it lasts for more than twelve months.

It appears from the above-mentioned that the first five articles contain a rule for determining in which State a person must be considered to be a resident for purposes of the convention and further contain different definitions.