VRIJE UNIVERSITEIT AMSTERDAM

VU Research Portal

Tax Treaty Residence of Entities

Gooijer, J.

2019

document version
Publisher's PDF, also known as Version of record

Link to publication in VU Research Portal

citation for published version (APA)
Gooijer, J. (2019). *Tax Treaty Residence of Entities*. [PhD-Thesis - Research and graduation internal, Vrije Universiteit Amsterdam].

General rights
Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

- Users may download and print one copy of any publication from the public portal for the purpose of private study or research.
- You may not further distribute the material or use it for any profit-making activity or commercial gain
- You may freely distribute the URL identifying the publication in the public portal

Take down policy
If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

E-mail address:
vuresearchportal.ub@vu.nl

Download date: 15. Feb. 2025

Summary

Only a resident of one of the contracting states can benefit from a tax treaty drawn up in accordance with the OECD MC. The personal scope of such a treaty is therefore partly determined by the meaning of the term 'resident'. The same term appears in many other provisions in the OECD MC. For the operation of these provisions, it is therefore also very important to determine exactly who qualifies as a resident. According to the first paragraph of Article 4, a person is a resident of a contracting state if he, "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". However, a person is not regarded resident if he "is liable to tax in that State in respect only of income from sources in that State or capital situated therein." If an entity is considered to be a resident of both contracting states based on the first paragraph, it should be determined on the grounds of the third paragraph of Article 4 in which of the two states that entity will be deemed resident. This study revolves around the question of when an entity qualifies as a resident within the meaning of Article 4. The following main questions are addressed: In its application to entities, does the definition of resident, contained within Article 4 OECD MC, effect conformity with the object of a treaty based on the OECD MC? If not, how should Article 4 OECD MC and/or the related Commentary be adjusted to meet the needs of a treaty based on the OECD MC?

Chapter 2 deals with the history of the treaty definition of Article 4(1) and the tie breaker of Article 4(3). Both provisions already appear in the first draft model tax convention that the OECD published in 1963, although some changes have been made since then. But even earlier, in the model tax treaties developed by the League of Nations, concepts have been used that can be found in the models of the OECD or the Commentary. Because the development of both the models of the League of Nations and that of the OECD shed light on the contents of the current treaty provision, this development is relevant when interpreting Article 4. Based on the history of the provision, it is established that the expression 'liable to tax by reason of ...' refers to concepts that have been (and still are) used in the domestic tax system of most states, to establish the residency of entities liable to taxation on their world income. Further conditions regarding the scope of the tax liability under national law are not set. Furthermore, it is concluded that in a critical evaluation of the current treaty definition, three items should be discussed: *(i)* whether a treaty definition is necessary, *(ii)* whether treaty benefits should accrue to permanent establishments and *(iii)* whether the definition of 'resident' should be changed insofar as the expression is relevant in the context of taxation by a source state.

In order to determine which requirements are imposed on a treaty resident, the various elements of the treaty definition have been interpreted. **Chapter 3** explains the approach on treaty interpretation applied in this study. In this respect the interpretation provisions of Article 3(2) of the OECD MC and Articles 31 and 32 of the VCLT play an important role, with

Article 3(2) being a *lex specialis*. If the meaning of undefined treaty terms cannot be derived from domestic law, or if the context requires another meaning, it is necessary to establish that meaning on the basis of the framework for interpretation provided in the Articles 31 and 32 VCLT. Firstly, the various elements that are of importance in treaty interpretation, such as the (literal) text, the context of the term, the object and purpose of the treaty and, finally, the principle of good faith, have been evaluated separately and, subsequently, the results have been weighed against each other. In that process, the OECD Commentary was used as a 'quasi context'. This commentary often sheds light on the 'ordinary meaning' of the expressions and helps determining the purpose and purport of the treaty. Case law has subsequently been used as a litmus test to critically evaluate the results of the interpretative process.

The object and purpose of a tax treaty based on the OECD MC is important in this study for two reasons. Firstly, the main question, pivotal to the research, refers to the purpose of tax treaties. Secondly, the object and purpose is relevant for the application of Article 31(1) of the VCLT. In **chapter 4** it has been established that the purpose of a tax treaty is to prevent double taxation and furthermore tax evasion and avoidance. Article 4 determines (partially) the personal scope of the treaty and plays a role in the application of the allocation provisions (chapters III and IV) and the regulations for preventing double taxation (Article 23A or 23B). The text of Article 4 and the explanatory notes contain only objective criteria for concluding residence status. Therefore, if the conditions are met, on the basis of the underlying motives for the establishment an entity cannot be denied the status of resident. Consequently, the prevention of tax evasion and avoidance cannot fulfill an important role for interpretative purposes. This of course does not mean that in situations of abuse treaty benefits cannot be denied.

Chapter 5 examines the effect of Article 4(1) if the provision is applied to entities. First the meaning of the various expressions under national law is sought, in particular 'under the legislation of that state', 'liable to tax', 'domicile', 'residence', 'place of management' and 'any other criterion of a similar nature'. It is concluded that in the national law of the countries which acted as reference (Germany, France, the Netherlands, the United Kingdom and the United States) the expressions used in Article 4 (1) are not defined, with exception of the term 'place of management'. However, because of the context of the term, that latter expression should also be interpreted according to its treaty meaning.

On the basis of an interpretation in accordance with the framework of Articles 31 and 32 of the VCLT, it is concluded that the above elements of the first sentence of Article 4(1) refer to the criteria used by states to establish residence based taxation, taxation of an entity's world wide income. Commonly used criteria are explicitly mentioned: domicile, residence and place of management. A similar criterion is any criterion on the basis of which a state applies or may apply residence taxation.

The second sentence of Article 4(1) still can exclude the treaty residence. This second sentence should be applied to entities and should lead to exclusion of entities as treaty residents of a state that are not fully under that state's taxing jurisdiction. In the context of the OECD MC, the expression 'income from sources in that State or capital situated therein' refers to the income allocated to the other state under the allocation provisions in the treaty. An entity is not liable to tax within the meaning of the second sentence if that entity can be liable to taxation only in respect of that income.

It follows that conduit companies, though these may effectively not be fully liable to tax as a result of a domestic measure, are not excluded as a result of the second sentence of Article 4(1) OECD MC. Such entities still are fully under that state's taxing jurisdiction. However, the second sentence may have such an effect on dual resident companies. These companies, as a result of the tie breaker provision of Article 4(3), may not be liable to tax under the second sentence in the loser state.

From the analyses in chapter 5, it follows that it is advisable to further clarify various elements of Article 4(1). Although its meaning in my view can be determined by means of the various methods of interpretation, there is no common understanding as to the meaning of some parts of the provision. This concerns the term 'liable to tax', in particular with regard to its application to subjectively exempt entities, and furthermore the terms in the second sentence of Article 4 (1) and its application to entities with double residence.

Chapter 6 deals with the tie breaker of Article 4(3), both that of the pre-2017 OECD MC and that of the 2017 OECD MC. In the pre-2017 OECD MC, the POEM is decisive: an entity is deemed to be a resident of the country in which the POEM is located. Although the text of the provision and the commentary on it give some direction with regard to the contents of this term, much uncertainty remains, especially as regards the level of management that determines POEM. With regard to the MAP, an amendment is recommended because of the non-mandatory nature of the procedure and the lack of clarity about the criteria to be applied by the states. Therefore it is concluded that the term POEM should be better defined and that the MAP should have a binding character. Moreover it should be made clear which criteria will be used to determine the place of residence and how these criteria relate to each other.

A proposal that avoids the uncertainties regarding a number of elements of Article 4(1) and 4(3) and corrects omissions, is presented in chapter 8. However, it is appropriate to consider in advance the conceptual prerequisites to which the resident concept must comply (**chapter 7**). The first established prerequisite is derived from the arguments that can be used to justify the recognition of an entity as resident for corporate taxation. The premise here is that only in case a state has a sufficiently justified claim with respect to a particular entity, that entity should also be regarded as a resident of that state for the application of the treaty. The anti-deferral character of corporation taxation is deemed decisive in this respect. It is concluded that the claim is justified provided that a source of income is located

in the state in question, in particular if a business activity and/or immovable property is located in that state. In that situation, the residency of the entity could best be linked to the location of such a source of income. With regard to the residency of an entity with income that cannot be allocated to a specific source (such as dividend, interest and royalties if the underlying shares, receivables and rights are not part of the assets of a business), it is the place where the shareholders are located that should be decisive.

Obviously this distinction, being based on the nature of the income with regard to the starting point for the location of an entity, is very difficult in practical terms. Many entities will have both forms of income, and affiliation to the place of residence or location of shareholders is particularly complicated with listed entities. Nevertheless, the distinction was used as a starting point in the development of a new treaty definition in chapter 8.

The second conceptual prerequisite for the novel definition relates to the scope of the tax jurisdiction of a state and the way in which it is defined in relation to that of other states. The principle of the 'closeness of connection' is used as the guiding principle. It considers whether there is a sufficient degree of economic allegiance of an entity with a state. In case a certain entity is economically and financially connected to two states, the tax jurisdiction must be divided according to the degree of allegiance.

Thirdly, **chapter 7** explores which policy considerations underlie the conclusion of a tax treaty. What do states intend to achieve when entering into such a treaty? The decisive factor is stimulating cross-border economic activities. Through a tax treaty such activities are encouraged by avoiding double taxation and providing certainty as to the tax treatment of income and capital in the countries involved. In order to ensure that this objective is achieved, it is important to distinguish artificial set ups from actual economic activities for which the treaty is intended. A dam must be raised against abuse of the tax treaty. Insofar as there can be abuse through the residency, the definition of resident is the appropriate place to combat this abuse through the introduction of substance requirement.

As announced above**, chapter 8** presents a proposal for a novel definition of resident, which aims to correct for the ambiguities and omissions of the existing definition and which - at the same time - as far as is reasonably and practically possible, meets the theoretical principles set out in chapter 7.

The proposed treaty provision comprises the following elements.

1) A direct reference to the domestic treatment of the entity: an entity that qualifies as a resident for the purposes of the taxes to which the convention applies is, in principle, also a resident for the purposes of the convention. Because of this direct reference, the expression 'liable to tax by reason of ...' is no longer necessary.

2) Sufficient substance as a condition for treaty residence: an entity should only be regarded as a resident if the activities of that entity can be considered to form

a permanent establishment within the meaning of article 5(1) OECD MC. With regard to the substance requirements to be introduced, the conditions set out in the Limitations on Benefits provision of Article 29 of the OECD MC have been considered. Due to the relative unfamiliarity of the vast majority of OECD member states with this provision (originating from the US), preference is given to the permanent establishment concept of Article 5 of the OECD MC.

3) A resident of a third State shall also be a resident of the tax treaty if and insofar as there is a permanent establishment (Article 5(1) OECD MC) of that resident in a contracting state.

4) For certain entities that do not fulfill the substance requirement, a separate measure should be considered. Pension funds and charitable institutions could be explicitly deemed as residents by means of a separate provision. Investment funds and investment institutions should be allegeable to treaty benefits if and insofar as the underlying participants would have received treaty benefits. Entities with investments in real estate should be regarded as residents of the state in which the real estate is situated, but only insofar as the income from that real estate is concerned. A separate arrangement should also be included for entities with a permanent establishment in the other treaty state. If such an entity is not considered to be a treaty resident, the state in which the entity is deemed resident under domestic law is not obliged to provide for the avoidance of double taxation in respect of the income attributable to the permanent establishment. Therefore, such an entity should be considered as a resident of the treaty with regard to that income.

5) Due to the substance conditions included in the proposed definition, the number of cases in which the proposal will involve dual residency is limited. Only in case an entity exercises activities in both contracting states that qualify under the substance test and certain income can not be attributed to these activities, a tie breaker should be decisive. It is proposed to use the place of the executive management of the entity as a tie breaker. If the place of executive management does not provide a solution, a compulsory MAP should be applied.

Finally, **chapter 9** provides answers to the pivotal question raised in this research. It is concluded that although the meaning of Article 4(1) and (3) can be established through generally accepted interpretation methods, it is advisable to clarify certain elements. This concerns in particular the 'liable to tax' test, the scope of the second sentence of Article 4(1) and the tie breaker of the third paragraph. Taking into account the conceptual theoretical assumptions set out in chapter 7, which lead to the introduction of substance requirements, a proposal has been presented for a novel treaty provision that contributes to the realization of the purpose of a tax treaty.