

UNIT 7:

INTERNATIONAL DOUBLE TAXATION RELIEF

7.1 WHAT IS DOUBLE TAXATION?

Double taxation occurs when tax is paid more than once on the same taxable income or asset.

Double taxation may be **economic** or **juridical**. Double taxation is economic if more than one taxpayer is taxed on the same income. For example, the profits of a company may be subject to corporate tax in the hands of the company and to withholding tax in the hands of the shareholders when the after-tax profits are distributed as dividends. Economically, the corporate profits and the dividends are the same income, however taxed in the hands of two different taxpayers – the company paying the corporate income tax and the shareholder – subject to the taxation on the distributed profits. Double taxation is juridical when the same taxpayer is taxed twice on the same income. For example, a resident of country A may earn dividend income from country B and this dividend income may be taxed, first, in country B (based on the source principle) by a way of withholding tax and then one more time in country A (based on the residence principle) by a way of tax assessment.

Double taxation may occur in both domestic and international (cross-border) situations. We will only be concerned with international juridical double taxation in this course.

International juridical double taxation

International juridical double taxation may arise where:

- (a) two States each subject the same person to tax on his worldwide income or capital; or
- (b) a person is a resident of one State (R) and derives income from, or owns capital in, the another State (S or E) and both States impose tax on that income or capital; or
- (c) two States each subject the same person, not being a resident of either State to tax on income derived from, or capital owned in, one of the States. This may result, for instance, in the case where a non-resident person has a permanent establishment in one State (E) through which he derives income from, or owns capital in, the other State (S).

7.2 METHODS FOR ELIMINATION OF INTERNATIONAL DOUBLE TAXATION

In general, there are two principal methods for elimination of international double taxation:

- (a) the exemption method, i.e. exempting foreign income from domestic taxation; and
- (b) the credit method, i.e. granting a credit for foreign taxes.

These two methods are set out in Articles 23A (exemption method) and 23B (Credit method) of the UN and OECD Model Conventions.

Exemption method

Under the exemption method, the State of residence R does not tax the income which may be taxed in State E or S. With the exemption method therefore, the country of residence leaves the taxing right solely with the source country, giving that country the responsibility to tax the source income according to its own tax rules and rates.

The principle of exemption may be applied by two main methods:

- (a) the income which may be taxed in State E or S is not taken into account at all by State R for the purposes of its tax; State R is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the rest of the income; this method is called “**full exemption**”;
- (b) the income which may be taxed in State E or S is not taxed by State R, but State R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income; this method is called “**exemption with progression**”.

Credit method

Under the credit method, the State of residence R calculates its tax on the basis of the taxpayer's total income including the income from the other State E or S which may be taxed in that other State. It then allows a deduction from its own tax for the tax paid in the other State. With the credit method therefore, the residence country gets a subsidiary tax right which will have its effect when the source country levies a lower tax than the country of residence, because then an additional amount of tax needs to be paid on the worldwide income.

The principle of credit may be applied by two main methods:

- (a) State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State, this method is called “**full credit**”;
- (b) the deduction given by State R for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State; this method is called “**ordinary credit**”.

Fundamentally, the difference between the exemption method and the credit method is that the exemption methods look at income, while the credit methods look at tax.

Countries using the exemption method reserve this mainly for “active income” such as business profits (through permanent establishments) and employment income, while they use the credit method for “passive income” such as interest, dividends and royalties.

Example

An artiste earns \$80,000 at home in State R (State of residence) and \$20,000 abroad in State S (State of source) = worldwide income of \$100,000.

In State R the tax rates are progressive, namely 35% (average) on an income of \$100,000 (= \$35,000) and 30% (average) on an income of \$80,000 (= \$24,000).

In State S the tax rate is 20% leading to \$4,000 source tax.

(a) *Initial tax liability*

Without any relief for double taxation, the total initial tax liability of the artist would be:

Tax in state R, 35 % of \$100,000	\$35,000
+ tax in State S	\$ 4,000
Total taxes in State R and State S	\$39,000

(b) *Full Exemption*

With the “full exemption”, the State R, State R, simply omits the foreign income from its own taxation and only imposes tax on the domestic income of 80,000, at 30%:

Tax in state R, 30 % of \$80,000	\$24,000
+ tax in State S	\$ 4,000
Total taxes	\$28,000

Tax relief given by State R = \$11,000 (i.e. \$39,000 - \$28,000)

(c) *Exemption with progression*

With the “exemption with progression”, domestic income is taxed at the tax rate for worldwide income, i.e. 35%:

Tax in state R, 35 % of \$80,000	\$28,000
+ tax in State S	\$ 4,000
Total taxes	\$32,000

Tax relief given by State R = \$7,000 (i.e. \$39,000 - \$32,000)

(d) *Full Credit*

With the “full credit”, the home country, State R, simply allows the deduction of the foreign-source tax from the tax calculated on worldwide income:

Tax in state R, 35 % of 100,000	\$35,000
less full tax in State S	\$ 4,000
Tax due	\$31,000
Total taxes in State R and State S	\$35,000

Tax relief given in State R = \$4,000 (i.e. \$39,000 - \$35,000)

(e) *Ordinary credit*

With the “ordinary credit”, the home country, State R, also allows a deduction of the foreign-source tax from the tax calculated on the worldwide income, but not more than the proportion of tax that would be attributable to the income from State S (maximum deduction). This limitation to the average tax rate is a maximum of 35% x \$20,000 = \$7,000:

Tax in state R, 35 % of \$100,000	\$35,000
Less tax in State S	- \$ 4,000
Tax due in state R	\$31,000
Total taxes in State R and State S	\$35,000

Tax relief given by State R = \$4,000 (i.e. \$39,000 - \$35,000)

In the above computation, the tax of \$4,000 paid in State S is less than the \$7,000 maximum deduction and therefore the entire \$4,000 tax paid in State S will be allowed as a deduction from the tax calculated on the worldwide income in State R.

If, however, State S had a tax rate of 40% this would lead to \$8,000 source tax, and total taxes in State R and State S would be \$43,000 (i.e. \$35,000 + \$8,000). In such case, State R would only allow a deduction of up to \$7,000 foreign-source tax from the tax calculated on the artist’s worldwide income. The computation of tax due in State R would be as follows:

Tax in state R, 35 % of \$100,000	35,000
Less maximum foreign-source tax	- 7,000
Tax due in state R	28,000
Total taxes in State R and State S	36,000

Tax relief given by State R = \$7,000 (i.e. \$43,000 - \$36,000)

Conclusions from Example

Of the two exemption methods, the “full exemption” is usually the most advantageous method for eliminating double taxation for the artiste in this example. The “full exemption” will be given against the marginal, highest applicable tax rate, while the “exemption with progression” allows the exemption against the average tax rate on the income in the country of residence. This makes a big difference in a country with steep progressive tax rates.

In any case, in both situations the tax relief can be more than the foreign-source tax, but can also be lower. This will happen sooner with the “exemption with progression” method than with the “full exemption” method, as the examples in (b) and (c) above show.

The “full exemption” method is regularly used for exemption in source States, but almost never for elimination of double taxation in the country of residence. Article 23A of the OECD Model Tax Treaty recommends the use of the “exemption with progression” method for countries that want to apply this to active foreign income.

An important difference in favour of the “exemption with progression” method is the treatment of foreign losses. They can be offset against other, domestic, positive income items and therefore bring down the taxable income in the country of residence. This is more profitable than under the “full exemption” method, where these foreign losses are included in the exemption.

From the two tax credit methods, the “full credit” gives the best result for the taxpayer. The tax relief from this method seems to be closest to the theory of “capital export neutrality”, because the total tax burden after the full tax credit is equal to the tax that would be due if the income were earned in the home country only. At first sight, it is a nicely balanced credit system, with the same overall tax burden regardless of whether the income had a domestic or foreign source.

But problems can arise for state budgeters when the foreign-source tax rate is higher than the tax rate in the country of residence. This was already recognized in 1921 in the United States, a mere 3 years after the foreign tax credit was introduced in the Revenue Act. The limitation to “ordinary credit” was enacted to prevent taxes from countries with income tax higher than that in the United States from reducing US tax liability on US-source income. The reason was that the income tax rates in the United Kingdom in those post-war years were so high that the United States was afraid that all domestic tax revenue would be wiped out by a full foreign tax credit. The United States stated the opinion that at least it wanted to collect the taxes that fairly belonged it. This provision still constitutes a fundamental basis of US law for taxing income earned abroad by US residents.

The United Kingdom also limits the tax credit to a maximum, which is the amount of UK tax attributable to the income which has been subject to foreign tax. This is the same for other countries using the tax credit system.

Article 23B of the OECD Model Tax Treaty follows the views of the United States and the United Kingdom and recommends in general the use of the “ordinary credit” method for countries wanting to apply the credit system to all types of foreign income, both active and passive. But the conclusion from the example is that this might lead to insufficient compensation for the foreign artiste tax, as shown in the example (e) above when the artist’s foreign-source tax was \$8,000.

Deduction method

The deduction method allows residents/citizens to deduct foreign taxes paid treating them as a current expense so it becomes the effective means of providing relief when there is no DTA.

Anyone in the United States with unlimited tax liability on his full worldwide income can choose not to take a tax credit for foreign tax, but to deduct the foreign tax as a business expense, so that the tax base will become considerably lower.

Germany also gives its residents with unlimited tax liability the option of choosing the deduction of the foreign tax from worldwide income as a business expense.

Deduction of foreign-source tax as an expense is allowable in the Netherlands when no DTA is applicable and the unilateral rules for elimination of double taxation apply, giving residents the option to choose between either an ordinary tax credit or the deduction of foreign tax from taxable income

When the foreign-source tax is high or domestic income is low or negative, the choice of a deduction as an expense might become advantageous.

7.3 UNILATERAL AND BILATERAL DOUBLE TAXATION RELIEF

Relief from double taxation can be provided in mainly two ways: (i) bilateral relief; and (ii) unilateral relief.

Bilateral Relief

Under this method, the Governments of two countries can enter into an agreement (known as a double taxation agreement (DTA) or double taxation treaty (DTT)) to provide relief against double taxation by mutually working out the basis on which the relief is to be granted. Zambia, for example, has entered into agreements for relief against or avoidance of double taxation with more than 10 countries which include the United Kingdom, Ireland, Switzerland, Sweden, Mauritius, South Africa etc.

Bilateral Relief may be granted by either the exemption method or credit method. In Zambia, double taxation relief is provided by a combination of the two methods.

Unilateral Relief

This method provides for relief of some kind by the country of residence where no DTA has been entered into with the country of source. Unilateral relief is normally allowed as a credit of the foreign tax against the income tax chargeable in the country of residence.

7.4 DOUBLE TAXATION RELIEF PROVISIONS UNDER THE INCOME TAX ACT

Sections 74, 75 and 76 of the Income Tax Act provide for international double taxation relief in Zambia.

Bilateral relief [Sections 74 and 75]

Section 74(1) of the Income Tax Act provides that the President may enter into a double taxation agreement with the Government of any other country:

- (a) for the granting of relief of tax or the prevention of double taxation in respect of income on which income-tax is payable in both Zambia and the foreign country has been paid both in Zambia and in that country or specified territory; or
- (b) for the rendering of reciprocal assistance in the administration of and collection of taxes under the income tax laws of Zambia and of such foreign country.

Following the President's entry into such an agreement with a Government of a foreign country, the agreement must be presented before Cabinet by the Minister of Finance for ratification and soon after ratification, the President is required, by statutory instrument, to notify the public of terms of the agreement. The agreement will have effect until such statutory instrument is revoked and for so long as the agreement has the effect of law in the other contracting country.

Double taxation agreements permitted under section 74(1) are intended to provide relief to the taxpayer, who is a resident of either Zambia or of the other contracting country to the agreement. Such taxpayer can claim relief by applying the beneficial provisions of either the agreement or the domestic law.

Section 75(1) provides that where a double taxation agreement applies to a Zambian-resident in respect of income earned in a foreign country and such agreement entitles the taxpayer to a credit of foreign taxes against Zambian taxes, the taxpayer will be allowed a credit of the foreign tax paid in respect of the foreign income against Zambian tax payable in respect of the foreign income. The amount of foreign tax allowed as a credit is, however, limited to the amount of Zambian tax that would be payable in respect of the foreign income (essentially relief is by way of an ordinary credit).

Unilateral Relief [Section 76]

In the case of income arising to a Zambian-resident taxpayer in countries with which Zambia does not have any double taxation agreement, relief would be granted under section 76 provided all the following conditions are fulfilled:

- (a) the taxpayer is a resident in Zambia;
- (b) the income accrues or arises to him outside Zambia;
- (c) the income in question has been subjected to income-tax in the foreign country in the hands of the taxpayer;
- (d) the taxpayer has paid tax on the income in the foreign country.; and
- (e) there is no double taxation agreement between Zambia and the foreign country.

In such a case, the taxpayer shall be entitled to a deduction of the foreign taxes paid from the Zambian income-tax payable by him. The deduction allowed, however, is limited to the amount of Zambian tax that would be payable in respect of the foreign income (essentially relief is by way of an ordinary credit).

7.5 DOUBLE TAXATION AGREEMENTS

A double taxation agreement (DTA), also known as a ‘tax treaty’ or ‘tax convention’ is an agreement entered into by the Governments of two countries with the broad objective of facilitating cross-border trade and investment by eliminating the tax impediments to these cross-border flows. This broad objective is supplemented by several more specific, operational objectives; the most important operational objective being the elimination of international double taxation. If income from cross-border trade and investment is taxed by two or more countries without any relief, such double taxation would obviously discourage such trade and investment. Many of the substantive provisions of the typical DTAs are directed at the achievement of this goal.

DTAs are generally based on certain models. The most common ones are:

- (a) the Organisation of Economic Co-operation and Development (OECD) Model Convention on Income and on Capital (the “**OECD Model Convention**”); and
- (b) the United Nations (UN) Model Double Taxation Convention between Developed and Developing Countries (the “**UN Model Convention**”).

In addition, many countries have their own model tax treaties, which are often not published but are provided to other countries for the purpose of negotiating tax treaties. The UN Model Convention draws heavily on the OECD Model Convention.

The OECD Model Convention

The OECD Model Tax Treaty is an accord reached between member states of the Organization for Economic Cooperation and Development (OECD) that serves as a guideline for establishing tax agreements. The convention consists of articles, commentaries, position statements and special reports on evolving tax issues. Its primary application is in guiding the negotiation of bilateral treaties between two or more countries.

Currently, the OECD has 34 members, consisting of many of the major industrialized countries. The OECD Model Convention was first published, in draft form, in 1963. It was revised in 1977 and again in 1992, at which time it was converted to a loose-leaf format in order to facilitate more frequent revisions. Since then, revisions have been made every few years, on nine occasions, most recently in 2014. The Committee on Fiscal Affairs (CFA), which consists of senior tax officials from the member countries, has responsibility for the OECD Model Convention as well as other aspects of international tax cooperation. CFA operates through several working parties and the Centre for Tax Policy and Administration, which contains the permanent secretariat for CFA. The working parties consist of delegates from the member countries. Working Party No. 1 on Tax Conventions and Related Questions is responsible for the Model Convention, and it examines issues related to it on an ongoing basis.

A detailed Commentary, organized on an article-by-article basis, accompanies the OECD Model Convention. The OECD Commentaries have become increasingly important with respect to the interpretation and the application of tax treaties, including some treaties between countries that are not members of the OECD. To take account of the positions of some non-member states, the OECD opened up the Commentaries in 1997 to many of them, including Argentina, Brazil, China, India, Russia and South Africa.

The OECD Model Convention favours capital-exporting countries over capital-importing countries. Often it eliminates or mitigates double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country. This feature of the OECD Model Convention is appropriate if the flow of trade and investment between the two countries is reasonably equal and the residence country taxes any income exempted by the source country. However, the OECD Model Convention may not be appropriate for treaties entered into by net capital-importing countries. As a result, developing countries devised their own model treaty under the auspices of the United Nations.

The UN Model Convention

The UN Model Convention forms part of the continuing international efforts aimed at eliminating double taxation. These efforts were begun by the League of Nations and pursued in the Organisation for European Economic Co-operation (OEEC) (now known as the OECD) and in regional forums, as well as in the United Nations, and have in general found concrete expression in a series of model or draft model bilateral tax conventions.

The work of the United Nations on a model treaty commenced in 1968 with the establishment by the United Nations Economic and Social Council (ECOSOC) of the United Nations Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries pursuant to its resolution 1273 (XLIII).¹ The Group of Experts produced a Manual for the Negotiation of Bilateral Tax treaties between Developed and Developing Countries which led to the publication of the UN Model Convention in 1980.² The Model Convention was revised in 2001 and again in 2011. In 2004, the Group of Experts became the Committee of Experts on

¹ Economic and Social Council resolution 1273 (XLIII) of 4 August 1967.

² UN Model Taxation Convention between Developed and Developing Countries (New York: 1980).

International Cooperation in Tax Matters.³ The Committee maintains detailed Commentaries on the UN Model Convention; it is also responsible for the publication of several useful manuals on tax issues important for developing countries, such as transfer pricing and the administration of tax treaties. The members of the Committee are tax officials nominated by their governments and appointed by the Secretary-General of the United Nations, who serve in their individual capacity. A small majority of the members of the Committee are from developing countries and countries with economies in transition. The UN Model Convention follows the pattern set by the OECD Model Convention and many of its provisions are identical, or nearly so, to those in that Model Convention. In general, therefore, it makes sense not to view the UN Model Convention as an entirely separate one but rather as making important, but limited, modifications to the OECD Model Convention.

The main difference between the two model Conventions is that the UN Model Convention imposes fewer restrictions on the taxing rights of the source country; source countries, therefore, have greater taxing rights under it compared to the OECD Model Convention. For example, unlike Article 12 (Royalties) of the OECD Model Convention, Article 12 of the UN Model Convention does not prevent the source country from imposing tax on royalties paid by a resident of the source country to a resident of the other country. The UN Model Convention also gives the source country increased taxing rights over the business income of non-residents compared to the OECD Model Convention. For example, the time threshold for a construction site permanent establishment under the UN Model Convention is only 6 months, compared to 12 months under the OECD Model Convention. In addition, furnishing services in a country for 183 days or more constitutes a permanent establishment under the UN Model Convention, whereas under the OECD Model Convention furnishing services is a permanent establishment only if the services are provided through a fixed place of business which, according to the OECD Commentary thereon, must generally exist for more than 6 months.

Comment on the UN and OECD Model Conventions

The success of the UN and OECD Model Conventions has been astounding. Virtually all existing bilateral tax treaties are based on them. Their wide acceptance and the resulting standardization of many international tax rules have been important factors in reducing international double taxation.

Changing the UN and OECD Model Conventions to correct flaws and respond to new developments is extremely difficult. One source of difficulty is that countries can bring their existing tax treaty networks into line with a revision to the UN or OECD Model Conventions only by renegotiating virtually all of their existing treaties. In contrast, the Commentaries to the UN or OECD Model Conventions are much easier to change than the Model Convention itself. Therefore, if a Commentary is revised, it may be possible for the tax authorities of countries to interpret existing treaties in accordance with it without the need to renegotiate existing treaties.⁴

Unlike the UN Model Convention, the OECD Model Convention reflects the positions of the member countries of the OECD. Member countries that disagree with any aspect of the OECD Model Convention can register a reservation on the particular provision. These reservations are found in the Commentaries to the Model Convention. A reservation indicates that the country does not intend to adopt the particular provision of the OECD Model Convention in its tax treaties. Most countries have entered reservations on some aspects of the Model Convention.

³ Economic and Social Council resolution 2004/69 of 11 November 2004.

⁴ The country's courts may take a different position and refuse to interpret the treaty in accordance with the revised Commentary.

For example, several countries have entered reservations on Article 12, dealing with royalties, by asserting their intention to levy withholding taxes on them.

The Commentaries on the OECD Model Convention also contain observations by particular countries on specific aspects of them. Countries register observations to indicate that they disagree with the interpretation of the treaty provided in the Commentary. A country making an observation does not reject the particular provision of the OECD Model Convention (in other words, it has not registered a reservation on the provision). The purpose of an observation is to indicate that the country may include the provision in its treaties but it will interpret and apply it in a manner different from the interpretation espoused in the Commentary.

Contents of a typical DTA

A typical DTA based on the UN or OECD Model Conventions will have the following basic structure and major provisions:

- **Chapter I – Scope of Treaty:** Chapter I consists of Article 1, which identifies the persons whose tax obligations are affected by the treaty, generally residents of the contracting States, and Article 2, which describes the taxes covered by the treaty, generally income and capital taxes imposed by the contracting States and their political subdivisions.
- **Chapter II – Definitions:** Chapter II provides definitions of important terms used in the treaty including general definitions in Article 3, a definition of the term “resident” in Article 4 and “permanent establishment” in Article 5.
- **Chapter III – Taxation of Income:** Chapter III contains what are often referred to as the distributive rules of the treaty. Articles 6-21 deal with various types of income derived by a resident of one or both of the States. In general, these provisions determine whether only one or both of the contracting States — the State in which the taxpayer is resident (the residence country) and the State in which the income arises or has its source (the source country) — or whether both of them can tax the income and whether the rate of tax imposed is limited. The Articles and the types of income are as follows:

Article 6 — Income from immovable property;

Article 7 — Business profits;

Article 8 — Income from the operation of ships or aircraft in international traffic and boats in inland waterways transport;

Article 9 — Profits of associated enterprises and transfer pricing;

Article 10 — Dividends;

Article 11 — Interest;

Article 12 — Royalties;

Article 13 — Capital gains;

Article 14 — Income derived from professional and independent services;

Article 15 — Income from employment;

Article 16 — Directors' fees and remuneration of top-level managerial officials;

Article 17 — Income derived by artistes (entertainers) and athletes;

Article 18 — Pensions and social security payments;

Article 19 — Income derived by government employees;

Article 20 — Income derived by students, business trainees and apprentices;

Article 21 — Other income; in other words, income not dealt with in Articles 6-20.

- **Chapter IV – Taxation of Capital:** Chapter IV deals with the taxation of capital (not income from capital).
- **Chapter V – Elimination of Double Taxation:** Chapter V provides two alternative methods for eliminating double taxation: (i) Article 23A (Exemption method) and Article 23B (Credit method). In general, if the contracting State in which income arises is entitled by the rules in Article 6-21 to tax the income, the contracting State in which the taxpayer is resident is obligated to provide relief from double taxation. Under the exemption method, the residence country excludes or exempts the income from residence country tax. Under the credit method, the residence country taxes the income but provides a deduction from that tax for the tax paid to the source country on the income.
- **Chapter VI - Special provisions:** Chapter VI provides for certain special provisions. Article 24 provides protection against various forms of discriminatory taxation by the source and residence countries. Articles 25, 26 and 27 provide for important types of administrative cooperation between the contracting States. Article 25 provides a mutual agreement procedure (MAP) to resolve disputes concerning the application of the treaty; Article 26 deals with exchanges of information between the States; and Article 27 provides rules for the contracting States to assist in collecting one another's taxes. Article 28 simply provides that nothing in the treaty affects the "fiscal privileges" enjoyed by diplomats and consular officials under international law or other international agreements.
- **Chapter VII – Final Provisions:** Chapter VII provides rules to govern the entry into force and termination of the treaty.

7.6 THE CONCEPT OF PERMANENT ESTABLISHMENT

Where two countries have entered into a DTA that provides for the avoidance of double taxation, usually the business activities of an enterprise that is resident in one of the countries (State R) are protected from taxation in the other country (State S) as long as those activities do not create what is known as a 'permanent establishment' (PE) in State S. Typically, a DTA defines a PE using the following two general tests:

- (a) whether the enterprise has a fixed place of business within the other country, as defined under the language of a specific treaty; and
- (b) whether the enterprise operates in the State S through a dependent agent that habitually

exercises the authority to conclude contracts on behalf of the establishment in the State S.

The definition of a PE is typically similar under both the OECD Model Convention and the UN Model Convention. However, a specific treaty should always be examined for exceptions or differences from standard language. In general, the UN Model Convention preserves greater source country taxation rights in Article 5, which addresses the economic nexus required before source country taxing rights may be exercised under the DTA.

Fixed place of business

Under the first prong of the PE test outlined above, an establishment must operate in State S through a fixed place of business to create a PE. A fixed place of business is typically defined to include the following types of physical locations:

- (a) a place of management;
- (b) a branch or an office;
- (c) a factory;
- (d) a workshop; and
- (e) a mine, oil, or gas well, quarry, or any other place where natural resources are extracted.

However, there are exceptions to these general types of locations that do not constitute a PE for treaty purposes. The exceptions usually include:

- (a) the use of a facility solely for the purpose of storage, display, or delivery of goods or merchandise owned by the establishment;
- (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purposes of storage, display, or delivery;
- (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise (or collecting information) for the enterprise;
- (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other preparatory or auxiliary activity;
- (f) the maintenance of a fixed place of business solely for any combination of the activities listed above.

Based upon the foregoing, an establishment has many options for doing business in State S without triggering a PE for treaty purposes. The analysis is highly fact-specific for each case, and the treaty language may vary depending upon the two countries involved in the analysis.

Using State S sales agent

A PE may also be created in State S if an establishment operates in that country through a dependent agent. Typically, tax treaties will provide the following general language addressing the use of agents in a State S:

An enterprise of a contracting state shall not be deemed to have a permanent establishment in the other contracting state merely because it carries on business in that other contracting state through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he/she will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.

Typically, the analysis to determine whether an agent is working as an independent agent can be determined by examining whether the agent is:

- (a) acting in the ordinary course of their business;
- (b) economically independent from the State R establishment that has contracted for their services; or
- (c) legally independent from the State R establishment that has contracted for their services.

Further, when examining the agency relationship, it is helpful to also identify the category of the agent that has been hired by the State R establishment. For example, agents can be considered any one of the following:

- (a) an importer or distributing agent;
- (b) a general sales commission agent; or
- (c) consignment agent.

Each type of agent must always be operating in the ordinary course of their business – and must meet the economic and legal independence tests to protect the State R establishment from being considered as operating a business through a permanent establishment in the State S. In all cases, consideration of the issues discussed above must be made when any enterprise is expanding their operations into a foreign country.

7.7 RELATIONSHIP BETWEEN TAX TREATIES AND DOMESTIC LAW

The relationship between tax treaties and domestic tax legislation is a complex one in many countries. The basic principle is that the treaty should prevail in the event of a conflict between the provisions of domestic law and a treaty. In some countries — France is an example — this principle has constitutional status. In many other countries, the government clearly has the authority under domestic law to override the provisions of a DTA. For example, legislative supremacy is a fundamental rule of law in many parliamentary democracies. As a result, it is clear in these countries that domestic tax legislation may override their tax treaties. However, the courts in these countries may require that the legislature explicitly indicate its intention to override a treaty before giving effect to a conflicting domestic law. Courts may also strain to find some ground for reconciling an apparent conflict between a treaty and domestic legislation.

In general, tax treaties apply to all income and capital taxes imposed by the contracting States, including taxes imposed by provincial (state), local, and other subnational governments. In some federal States, however, the central government is constrained by constitutional mandate

or established tradition from entering into tax treaties that limit the taxing powers of their subnational governments. Accordingly, the tax treaties of such federal States apply only to national taxes. This is the situation for both Canada and the United States of America. In such circumstances, a subnational government may impose taxes in a manner that would not be permitted for its central government.

In general, tax treaties do not impose tax. Tax is imposed by domestic law; therefore, tax treaties limit the taxes otherwise imposed by a State. In effect, tax treaties are primarily relieving in nature. Similarly, tax treaties do not allocate taxing rights, although it is often claimed that they do. In light of this fundamental principle, it is usually appropriate before applying the provisions of a DTA to determine whether the amount in question is subject to domestic tax. If the amount is not subject to tax under domestic law, it is unnecessary to consider the treaty. For example, assume that under the provisions of a treaty between country A and country B, interest paid by a resident of one State to a resident of the other State is subject to a maximum rate of withholding tax of 15 per cent. If, under the law of country A, interest paid by a corporation resident in that country to an arm's-length lender resident in country B is exempt from tax by country A, the treaty does not give country A the right to impose a 15 per cent withholding tax on the interest.

However, whether tax treaties give a right to tax independent of domestic law is a question of domestic law. The internal law of a few countries — France is an example — provides that they have the right to tax under domestic law any amount that they are not prevented from taxing under the terms of the treaty.

The provisions of tax treaties do not displace the provisions of domestic law entirely. Consider, for example, a situation in which a person is considered to be a resident of country A under its domestic law and is also considered to be a resident of country B under its domestic law. If the person is deemed to be a resident of country A pursuant to the tie-breaker rule in the treaty between country A and country B (Article 4 (2) (Resident) of both the UN and OECD Model Conventions provides a series of rules to make a person who is resident in both countries a resident of only one country for purposes of the treaty), the person is a resident of country A for purposes of the treaty but remains a resident of country B for purposes of its domestic law for all purposes not affected by the treaty. Thus, for example, if the person makes payments of dividends, interest or royalties to non-residents of country B, the person will be subject to any withholding obligations imposed by country B on such payments because the person remains a resident of country B.

Occasionally, some countries have passed legislation to modify or overturn the interpretation of a DTA given by a domestic court. Such legislation, adopted in good faith, may not violate a country's obligations under its tax treaties. Often the country overriding its tax treaties in this way will consult with its treaty partners to demonstrate good faith and to prevent misunderstandings.

Some countries may seek to prevent court challenges to certain domestic tax legislation on the basis of the country's tax treaties by providing that the new legislation prevails over any conflicting provisions of a DTA. The most well-known and controversial treaty overrides are probably those adopted by the United States; however, other countries have also done so on occasion. Treaties are solemn obligations that should not be disregarded except in extraordinary circumstances. At the same time, countries must have the ability to amend the provisions of their domestic tax legislation to keep it current and to clarify interpretative difficulties.

Many of the provisions of tax treaties do not operate independently of domestic law because they include explicit references to the meaning of terms under domestic law. For example, under Article 6 (Income from immovable property), income from immovable property located

in a country is taxable by that country. For this purpose, the term “immovable property” has the meaning that it has under the domestic law of the country in which the property is located. In addition, Article 3 (2) (General definitions), which is discussed below, provides that any undefined terms in the treaty should be interpreted to mean what they mean under the law of the country applying the treaty. Conversely, in some countries where domestic law uses terms that are also used in the treaty, the meaning of those terms for purposes of domestic law may be interpreted in accordance with the meaning of the terms for purposes of the treaty.