

Training Material  
HRM Wing (FBR) - GIZ

# Cross Border Transactions and Tax Treaties

Tax Reform Component  
Governance Programme

**giz** Deutsche Gesellschaft  
für Internationale  
Zusammenarbeit (GIZ) GmbH



# PART ONE

# PART ONE

- Cross Border Transactions and Role of Tax Treaties
- Objectives of Tax Treaties
- Major Concepts Under Tax Treaties
- Rules Governing Interpretation of Tax Treaties
- International Aspects of Income Tax Ordinance 2001

# Cross Border Transactions and Role of Tax Treaties

- Cross border transactions encompass transfer of
  - Goods,
  - Services,
  - Capital, and
  - Technology
- More than one country has a taxation claim on income from such transactions
- As a consequence
  - Same Income Taxed Twice
  - Economic Double Taxation Occurs

# Objectives of Tax Treaties

- **Primary Objectives**
  - Avoidance of Double Taxation
  - Prevention of Fiscal Evasion
- **Secondary Objectives**
  - Promote international trade
  - Create certainty and tax stability
  - Provide mechanism for resolution of international disputes
  - Promote tax incentives by the developing countries
  - Allocate taxing rights between contracting states
  - Prevent tax discrimination

# Cross Border Transactions and Role of Tax Treaties

- **Double Taxation because of:**
  - Dual Residency Claim – *Concurrent Liability to Tax*
  - Dual Source Claim – *Concurrent Limited Liability to Tax*
  - Competing Residence/Source Claims – *Conflict of Residence Against Source*
  - Adjusting Profits Claims – *Economic Double Taxation*
- **Double Taxation avoided by**
  - Allocating taxing rights to one or the other country
  - Allocating taxing rights to both countries with limitation in source state
  - Providing tax relief in source state where income is taxed in both states,
  - Providing ‘Tie Breaker Provisions’ in cases of ‘Dual Residence’

# Concept of Double Taxation -Explained -

- **Dual Residency Claims**  
Resident in both states and taxed on the same income or capital
- **Dual Source Claims**  
Each state treating income from sources therein
- **Competing Residency/Source Claims**  
Resident of one state derives income sourced in other state and both countries tax the same item of income
- **Adjusting Profits Claims**  
Up-ward adjustment of profits by source state without the residence country making consequential compensatory adjustments

# Major Concepts under Tax Treaties

- Scope of Tax Treaties
- Residence of Persons Covered under Tax Treaties
- Source of Income
- Rules Governing Interpretation of Tax Treaties
- Definition of Terms used in Tax Treaties
- Permanent Establishment/Fixed Place
- International Profit Allocation
- Transfer Pricing
- Protection of Investment Incentives
- Exchange of Information
- Dispute Resolution



# Scope of DTAs

- DTAs apply to Persons resident of one or both states
- Persons include both **natural and juristic** persons
- Taxes Covered –
  - Depending on the nature of DTA, Income/Capital Taxes imposed by the State, its political sub-divisions and local authorities.
  - Any identical or substantially similar taxes subsequently imposed
- Inappropriate use of DTAs not permitted
- Some examples of Inappropriate use
  - A person - whether or not resident of a state), acting through a legal entity created in a State essentially to obtain treaty benefits otherwise not available directly to such person
  - An individual having in a state both his **permanent home and all his economic interests** transferring **his interests** to the other state for tax advantage relating to low taxation of capital gains.
  - Use of base and conduit companies interposed in a country which has a favorable DTA with source country

# Article 4 of Model Convention

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, 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, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
  
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
  - a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
  - b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
  - c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
  - d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

# Article 4 of Model Convention

(Continued)

3. Where-by reason of the provisions of paragraph 1 a person other than an individual is **a resident of both Contracting States**, then it shall be deemed to be a resident only of the State in which its **place of effective management** is situated.

# Concept of Residence under DTAs

- DTAs adopt concept of residence as in National Tax Statutes:
  - Domicile, Residence, Place of Incorporation / management/effective management, other.
- Resolution of Dual Residence of Individuals through ‘Tie Breaker Rules’
  - Permanent home available to an individual gets first preference.
  - Where he has permanent home in both states, preference goes to state with which he has closer personal and economic relations
  - Where he has no permanent home in any of the states and his place of vital economic interest can not be determined, preference goes to the state where he has habitual abode.
  - Where he has habitual abode in both the states or neither of them, state of which he is national shall be his residence country.
- Resolution of Dual Residence of Juridical Persons
  - Place of Effective Management in case of dual residence
- Effective Management - Country where highest level of recurring operational management decisions are taken

# Effective Management

- **In Swiss practice**, a distinction is drawn between the **place of effective management** and merely **administrative management or decision making by executive bodies** (*e.g.* Where the decisions of a board of directors are limited to control of the company and to basic decisions). Although there are no court decisions on the meaning of the term “place of effective management”, it would be expected that the same interpretation would apply to the term as used in Swiss treaties and its domestic law.
- **According to the German case law**, a **place of management is regarded as the place where the management’s important policies are actually made** “**What is decisive is not the place where the management directives take effect, but rather the place where they are given.**” It is the centre of top level management, i.e. the place at which the person authorized to represent the company carries on his business managing activities. If a controlling shareholder does in fact manage the conduct of the company’s business, then that shareholder may be regarded as being in charge of the top level management, and the place where those decisions are made would appear to be the centre of management. However a place from which a business is merely supervised would not qualify.

If the place of management cannot be determined by the application of these criteria, the top manager’s place of residence may determine the residence of the company.

# Effective Management

## *key factors in determining a place of effective management*

A place of effective management will generally be where key management and commercial decisions necessary for the conduct of a business are in substance made and given. This will ordinarily be where the directors meet to make decisions relating to the management of the company.

Determination of a place of effective management is a question of fact and other relevant factors taken into account by the courts have included:

- Where the centre of top level management is located.
- Where the business operations are actually conducted.
- Legal factors such as the place of incorporation, the location of the registered office, public officer, etc.
- Where controlling shareholders make key management and commercial decisions in relation to the company; and
- Where the directors reside.

# Effective Management

*key factors in determining a place of effective management* (Continued)

- While the guidance from *Central Management & Control* and the *Place of Management* indicates the place of effective management will ordinarily lie with the directors, in certain circumstances these strategic decisions and powers may be exercised by others.
- For example, the guidance provided in paragraph 24 of the Commentary on Article 4 of OECD Model Convention , makes it clear that the relevant consideration is where the high level decision making occurs. If this function is performed by persons other than the Board of Directors, then the relevant consideration is the place where those other people make their decisions.

# Effective Management

## *Place of effective management in multi-jurisdictions (Continued)*

- ❑ The characteristics of effective management may exist in a number of jurisdictions and it may be said to exist simultaneously in more than one jurisdiction without a specific single jurisdiction being dominant. Thus to the extent that the place of effective management test fails to provide a clear allocation of residence to one country, albeit in a limited number of cases, it may be seen to be an ineffective rule.
  
- ❑ In order to achieve a tie-breaker rule that will produce a single territory result in all cases, the following options may be considered:
  1. Replace the place of effective management concept.
  2. Refine the place of effective management test.
  3. Establish a hierarchy of tests, as in the individual tie-breaker so that if one test does not provide an outcome, the next test will apply; or
  4. A combination of 1 and 2 above.



## Classification of Income and Capital for Taxation Purposes

- Income which may be subject to tax without limitation in the state of source or situs;
- Income which may be subject to limited taxation in the state of source; and
- Income which may not be taxed in the state of source or situs

## Income and Capital Taxable in Country of source or Situs Without Limitation

- Income from Immovable property situated in a state, gains from such property
- Income of PE, Gains from alienation of PE except PE maintained for international air and shipping traffic.
- Income from activities of artists and athletes
- Income from independent personal services attributable to FB. Gains from alienation of such FB
- Remuneration in respect of employment in private sector(including Directors' Fees unless it does not meet the prescribed conditions
- Other income items not covered specifically in the DTA

## Income Which May be Subject to Limited Taxation in State of source or Situs

- Dividends provided holding in respect thereof is not effectively connected to a PE or FB situated in source state
- Interest and Royalties provided not effectively connected with a PE or FB situated in source state.
- Pensions and Annuities subject to specific rules.

## Income and Capital which may not be taxed in Source State

- Other Items of Income except where DTA specifically provides for it.
- Examples of such income
  - Gains from alienation of shares or securities value of which is not derived principally from real estate
  - Payments received by students for the purposes of education or training
  - Capital represented by shares or securities

## Rules Governing Interpretation of Tax Treaties

- DTAs are contracts between two states.
- DTA language not as precise and detailed as in national taxation laws.
- Most states work with the drafting of OECD/UN Models.
- DTAs have force of law / adopted by the Parliament or other designated Agencies.
- While interpreting DTAs:
  - DTAs must be read keeping in mind its primary objectives.
  - Should DTAs be interpreted by the
    - Application of ordinary rules of statutory interpretation or
    - Generally accepted Rules of International Law?
  - Whether interpreted strictly or liberally ?

# Rules Governing Interpretation of Tax Treaties (Continued)

## -National Tax Statutes -

- While interpreting National Taxation Laws:
  - Read the Letter of the Law rather than its Spirit i.e. **strictly interpreted**,
  - Subject can not be taxed by inference or analogy, and
  - No governing principle to look at but to see whether tax claimed is that imposed by the statute
- While construing National Taxation Laws, it is not the function of Courts to:
  - Give to the words used a strained or un-natural meaning, or
  - Plug any lacuna or loop hole by a strained construction to the supposed legislative intention, or
  - Hunt out ambiguities by un-natural construction of a taxing provision, or
  - Whittle down operation of taxation statutes.
- On the contrary, Courts must
  - Give effect to the legislative intentions as gathered from the language employed in its context,
  - Read the taxation statute as a whole with a view not to defeat the legislative intentions

# Rules Governing Interpretation of Tax Treaties (Continued)

## - DTAs -

- Contrary to National Tax Statutes, DTAs be interpreted more **Liberal**ly and with extended construction.
- National Tax Statutes generally incorporate DTAs to avoid conflict .
- Courts have , as a matter of practice, accepted the DTAs interpretation , being an international agreement, governed by Public International Law as incorporated in Vienna Convention on the Law of Treaties of 1969 – more specifically Art. 31 to 33.
- Courts have also held that “*we can not expect to find the same niceties of strict definition as in modern documents, such as deeds or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use accuracy, but rather to adopt more liberal terms*”.

# Rules Governing Interpretation of Tax Treaties (Continued)

## - DTAs -

- **Interpretation of Treaties authenticated in two or more languages**
  - Text in both languages equally authentic unless otherwise provided
  - Terms of the treaties are presumed to have same meaning in each authentic text.
  - Art. 33 of Vienna Convention governs the above.
- **Can a DTA over-ride the National Law?**
  - Static vs. Ambulatory Approach in treaty interpretation.
  - Yes, DTA provisions over-ride those of national law
  - The “Treaty Over-rides” equally refers to enactment of subsequent national legislation which conflicts with obligations undertaken in the prior binding DTA.
  - **Can a DTA impose a higher tax burden than that in the National Law?**
  - DTAs only provide relief from tax.
  - DTAs do not impose a higher charge than under the National Law.
  - Reduction in tax rates or exemption granted under National Laws continue to operate even if the DTA entitles the state to tax a particular income.



# PART TWO

FBR - GIZ Cross Border Transactions and Tax  
Treaties

# PART TWO

- Elimination of Double Taxation
  - Methods for Elimination of Double Taxation
  - Operation of Various Methods
  - Key Points for Operation of Credit Method
  - Operation of Tax Sparing Credit
  - Practical Examples for Elimination of Double Taxation Under Various Methods
- Exchange of Information
  - Taxes Covered
  - Purposes for which information can be exchanged
  - Obligations and Limitations
  - Potential Legal Problems in Exchange of Information
  - Methods of Exchange of Information

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# **Elimination of Double Taxation under DTAs**

# Article 23 of Model Convention

## CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
  - a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
  - b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

# Alleviation of Double Taxation through Unilateral Measures

- Granting Unilateral Tax Incentives
  - Exemptions
  - Low Tax Rates Included
  - Extra Deductions for Business Expenses
  - Reductions of Withholding Taxes
  - Accelerated Depreciations
- Not Beneficial if
  - Residence Country does not exempt foreign source income or
  - Restrict tax credit to the extent tax paid abroad
- Double Taxation Not Fully Eliminated because of the Diversity in Tax Systems

## Alleviation of Double Taxation through DTAs

- DTAs Attempt to alleviate Double Taxation by
  - Reconciling differences in concepts of various incomes and their geographical source
  - Establishing a common method for classification of various items of incomes
  - Assign jurisdiction over various incomes to one or the other state
  - Grant relief which some states are not willing to offer unilaterally –Tax Sparing Credit

# DTAs Modify National Tax Laws in the Process by ---

- Allocating taxing rights to one or the other country
- Allocating taxing rights to source country but limiting its right therein
- Where income is taxed by both states, **providing tax relief in the country of residence** for tax paid at source
- In cases of dual residence, allocating taxpayer's residence to one or the other state through '**Tie Breaker**' provisions
- Setting out rules for determination of source of certain items of income

# Methods for Elimination of Double Taxation Under DTAs

- Exemption Method
- Credit Method
- Deduction Method
- Tax Sparing Credit Method



# Methods for Elimination of Double Taxation Under DTAs (Continued)

- **Exemption Method**
  - Foreign Source Income is exempted in the country of residence
    - Exemption with Progression
    - Exemption without Progression
- **Credit Method**
  - Credit for the foreign tax against the tax payable in Residence State but limited to the amount of tax payable therein.
- **Deduction Method**
  - The amount of foreign tax is deducted from the total income
- **Tax Sparing Credit Method**
  - The amount of foreign tax payable but exempted/reduced at source as part of its incentive program given credit against tax payable in Residence State but limited to the extent payable therein

# Elimination of Double Taxation Through Various Methods

	Exemption	Credit	Deduction
Income	100	100	100
Source Tax (@20%)	20	20	20
Residence Income	0	100	80
Residence Tax (@50%) (Before Tax Credit)	0	50	40
Residence Tax (After Tax Credit)	0	30	40
After Tax Income	80	50	40

**Tax Sparing Credit:** Where the source state exempts its tax, country of residence stills considers it as tax paid abroad and gives credit there for.

# **Elimination of Double Taxation under Tax Credit Method**

## **Key Points to Remember**

- Whether foreign tax has been actually paid.
- Certificate of tax withheld by payer of interest, dividends, royalties, employment income
- Assessment order issued by foreign tax authority
- Tax for which credit is given must be the Final Tax payable in respect of that income.
- Foreign tax must be covered under DTA.
- Consistent practice in foreign exchange conversion rate in respect of foreign tax.
- Limiting tax credit to the tax payable in country of residence in cases of ‘economic double taxation’

# Exchange of Information

# Exchange of Information

- Taxes Covered
- Purposes for which Information can be exchanged
  - Application of the Convention
  - Implementation of the domestic taxation laws
- Obligations and Limitations
  - Disclosure of Information Contrary to Public Policy
  - Information containing trade and business secrets
  - Secrecy Provisions
  - Bank Secrecy
  - Authorization for Exchange of Information
- Definitions
  - Fraud and Fiscal Evasion
  - Tax Evasion
  - Tax Avoidance
- Exchange of Information Provisions other than those of Art 26

# Methods for Exchange of Information

- ❖ Routine Transmittal of Information
- ❖ Transmittal on Specific Request
- ❖ Transmittal of Information on Discretionary Initiatives of Transmitting Country
- ❖ Industry-wide Exchange
- ❖ Simultaneous Audits

## Methods for Exchange of Information(Continued)

- **Routine Transmittal of Information**
  - Items Covered
    - Regular Sources of Information
      - Transactions related to treaty itself
      - Transactions involving Taxpayer Activity
      - Transactions related to special aspects of domestic law of Transmitting Country
      - Transactions relating to activities in the transmitting country of residence of the receiving country
      - General information concerning tax laws, administrative procedures of the Transmitting Country
- **Transmittal on Specific Request**
  - Particular Taxpayers
  - Particular Type of Transactions or Activities
  - Administration of Specific Requests for Information Received from Treaty Partner
- **Transmittal of Information on Discretionary Initiatives of Transmitting Country**
- **Industry-wide Exchange of Information**

# Exchange of Information

## Operational Aspects to be Considered in Respect of Routine Transmittals

- A minimum floor amount may be fixed to limit minor data
- The routine source of income items may be rotated from year to year – dividends in one year; interest in the other year;-----
- Information to be exchanged routinely may not be strictly reciprocal.
- Indications respecting degree to which the capital or other asset producing income flows are escaping tax
- Whether the information items should cover only the payee or payer as well
- Whether the information should cover only Receiving Country's residents or also those domiciled therein or citizens thereof.
- The degree of detail involved in the reporting
- The form and language in which the information should be provided.



# Exchange of Information

- Factors to be considered by Transmitting Country
- Factors to be considered by Receiving Country
- Co-operation Through Multi-lateral Tax Treaties
  - General Remarks
  - Limits to Provide Assistance
  - Protection of Taxpayers
  - Confidentiality
  - Conflict of Rules
- General Operational Aspects to be Considered
- Use of Information Received
- Competition Amongst Several Competent Authorities

# PART THREE

FBR - GIZ Cross Border Transactions and Tax  
Treaties

# PART THREE

- Concept of Permanent Establishment
- Taxation of Business Profits
- Taxation of Income from International Traffic  
(Only for LTU Karachi)

# Article 5 of Model Convention

## Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a **fixed place of business through which the business of an enterprise is wholly or partly carried on.**
2. The term "permanent establishment" includes especially:
  - a) a place of management;
  - b) a branch;
  - c) an office;
  - d) a factory;
  - e) a workshop, and
  - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

# Article 5 of Model Convention

## Permanent Establishment

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
  - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose 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 of 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 activity of a preparatory or auxiliary character;
  - g) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

# Article 5 of Model Convention

## Permanent Establishment

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

## Article 5 of Model Convention

### Permanent Establishment

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that 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.
  
7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

# Concept of Permanent Establishment

- THE Legal Concept of PE is a compromise between *source state taxation* and *residence state taxation*
- PE underlines that a state has a right to tax a foreign enterprise **if** it has a PE in that state
- PE concept together with Arm's Length Principle stands out as one of the most important legal concept in international tax treaty law.
- PE Principle originally developed with rather broad meanings under German Law – subsequently adopted in DTAs.



## Concept of Permanent Establishment (Continued)

- THE Legal Basis of PE can be one or more of the following alternatives:
  - *Basic Rule PE*: Business activity performed through fixed place of business.
  - *Construction PE*: Where *Basic Rule PE* does not exist but the business activity of the enterprise comprises performance of a construction or installation project at a building site for a prescribed period or more.
  - *Agency PE*: Where *Basic Rule PE* and/or *Construction PE* does not exist but business is conducted through a person authorized to conclude contracts for or on behalf of a foreign enterprise under prescribed conditions.

## Concept of Permanent Establishment (Continued)

### - Basic Rule PE -

- **Basic Rule PE is established provide following conditions are met:**
  - There exists a Place of Business
  - Place of Business is located at a certain area.
  - Person carrying out Business Activity has a Right to Use the Place of Business;
  - The Use of Place of Business must last for a Period of Time.
  - Activities performed through the Place of Business is Business Activity as defined in the DTA and Domestic Law

# Concept of Permanent Establishment (Continued)

## - Basic Rule PE -

### Place of Business Test

- *Place of Business* - Physical objects commonly suited to serve as *basis of a business activity*
- Examples of Positive List of Place of Business:
  - Branch, Office, Factory, Mine or Gas or Oil well, Quarry or any other place of extraction of natural resources.
  - Real estate, building, plant/machinery/equipment, ships, aircraft, drilling rigs, computers.
  - Vending machines, telephone exchanges, automatic filling stations, receiving and transmitting radio equipment and other non-staffed activities
  - Machinery and equipment of certain significance.
  - Extraction of all natural resources that are stationery extracted on-shore or off-shore.

# Concept of Permanent Establishment (Continued)

## - Basic Rule PE -

The Location Test

- Place of Business must be located at a specific place within the taxing jurisdiction of source state.
- A Business Activity which, by its name, can not be located in a particular place meets the *location test* i.e. Road Construction, Pipe Laying
- Where Core activities must be performed through the Place of Business
- Combination of Place of Business for preparatory or auxiliary activities with the conduct of core activities outside the Place of Business - meets *location test*
- Preventive maintenance and quality control constitutes PE **if** a part of it is performed in an office or similar activity on the rig.
- Peripatetic Place of Business inconsistent with location test - some states depart from this approach with respect to off-shore business activities e.g. Rig even if it moves frequently.

# Concept of Permanent Establishment (Continued)

## - Basic Rule PE -

### Right to Use Test

- Right of Use to Business Place i.e. ownership, lease or any other legal right to use.
- Examples
  - In case of profit sharing arrangements deemed Right of Use to partners' for partners located in another country.
  - Use of Clients' facilities where assignment requires physical presence in source country.
  - Where franchisee is required to adopt franchiser's trade identity, sell his products as well as accept the training, guidance and advertisement.
  - Gaming and Vending Machines where activities exceed mere setting up.
- Application of Right to Use Test to business performed at Arm's Length requires physical presence in source country (except beneficiaries of trust and members of cooperatives)

# Concept of Permanent Establishment (Continued)

## - Basic Rule PE -

### Permanence Test

- Use of Place of Business must be for a substantial period of time.
- Permanence does not denote Perpetual Use.
- Intended Permanence sufficient to coincide with Basic Rule PE.
- Objective rather than Motive Tests used in practice.
- Duration Test may be applied retroactively where an assignment or series of assignments even if initially there was no intention to do business for a substantial time.
- Duration Test - time starts running from the first day use of Business Place. Period required to establish Place of Business not counted. PE ceases to exist on termination of legal right to Place of Business

# Concept of Permanent Establishment (Continued)

## - Construction Clause PE -

- Covers activities of construction, installation, assembly projects not meeting Basic Rule PE.
- Duration Test as the primary criteria for treating such activities as PE.
- Projects at one or more sites constitute a PE if one or more projects last longer than prescribed period.
- Place where such activities are performed is the Place of Business.
- Relocation of projects e.g. road construction, row of houses, laying of pipeline, deemed to exist even if several clients involved.
- Important issues :
  - What is considered ‘one site’ as against ‘more sites’
  - Computation of Period (Beginning, and Termination and Interruptions)
  - What business activities may constitute ‘Construction’ or ‘Installation’?

# Concept of Permanent Establishment (Continued)

## - Construction Clause PE -

### What is One Site?

- Identification of several contracts permitted if the main project lasts longer than prescribed period.
- Commercial vs. Geographical Unity
- Specific factors considered regarding ‘Commercial Unity’ as against ‘Geographical Unity’ are
  - Contract
  - Client
  - Time Factor, and
  - Construction Activity
- Division of a project into more than one contract does not necessarily leads to ‘more than one contract’.
- Working period of sub-contractors is attributable to the contractors.



# Concept of Permanent Establishment (Continued)

## - Construction Clause PE -

### How is Time Period Computed?

- Period starts on the day the
  - Contractor or its First employee arrives at the site or
  - First delivery of equipment or building material made on the site which ever is earlier.
- The site ceases to exist when the
  - last employee permanently leaves, or
  - when remaining materials and equipment are removed
  - which ever is later
- Temporary Interruptions are counted as working time

# Concept of Permanent Establishment (Continued)

## - Construction Clause PE -

### **What constitutes construction or installation work?**

- Activities that precede (e.g. demolition ) and follow (maintenance)
- Actual construction work
- Activities performed during construction projects (supervisory activities)
- Some Examples:
  - Building of Test well and related activities
  - Laying of Asphalt on a new road
  - Scaffolding
  - Erection of barracks for use during the project
  - Dredging
  - Demolition
  - Planning and management of construction project

# Concept of Permanent Establishment (Continued)

## - Agency Clause PE -

- PE constituted where an enterprise carries on business through a dependent Agent
- Agency Clause
  - replaces the Fixed Place of Business Test and requirement of a business activity (i.e. Negative List)
  - does not require personal representation
- Agent's connection (residence/habitual abode) with source state required.
- Agent must have the authority to bind the principle.
- Agency can be based on a contract between agent and principal authorizing the Agent to act subject to Principal's instructions OR employment.
- General Authority means that Agent is empowered to perform all acts of a special class or series as opposed to particular acts .

# Concept of Permanent Establishment (Continued)

## - Agency Clause PE -

- Agent must be legally and commercially dependent upon the principal.
- Independent Agents do not constitute PE unless they act outside their course of business
- An Agent must habitually use his powers to conclude contracts to constitute PE.
- Authority deemed to be exercised where a person authorized to negotiate a contract binding the enterprise even if the contract is signed by other person in the other state of residence of enterprise.

# Concept of Permanent Establishment (Continued)

## - PE Through Associated Enterprises -

- PE not constituted through the mere control or ownership of capital.
- A subsidiary PE may be constituted under the same conditions that create a PE for unrelated enterprises.
- A subsidiary PE is created if
  - it is authorized to conclude contracts for or on behalf of the enterprise (parent company) and all conditions under Agency Clause are satisfied.
  - Where it is a place of management of the parent or vis-a-versa, or if two affiliates perform joint business.
  - Where a contract between the subsidiary and the client requires participation of the parent company or the equipment or know-how of the parent company.

# Article 7 of Model Convention

## Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

# Article 7 of Model Convention

## Business Profits

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
  
4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

# Article 7 of Model Convention

## Business Profits

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.



# Taxation of Business Profits

- Primary Right of Taxation of foreign source income vests with Residence Country.
- The other state has the right to tax only if the enterprise carries on business therein through a PE.
- Depending upon the provisions of a DTA, such income is taxable in the other state to the extent
  - Income attributable to PE (attribution principle)
  - Income attributable to PE as well as income earned by the enterprise through direct sale of goods of similar nature (mild force of attraction principle)
  - All income of the enterprise (force of attraction Principle)
- Income allocation between Enterprise and its PE on Arm's length basis.
- All expenses incurred in earning PE's income allowed as deduction.
- Apportionment of profits between enterprise and its PE on a basis other than above permissible if results in line with the general principle of Art. 7.
- Method of income computation to be consistent over time.

# Taxation of Business Profits

## What constitutes business?

- The expression used in taxing statutes in the sense of occupation or profession which occupies the time, attention and labour of a person normally with the object of making profits. It is not a legal term and its dictionary meanings embraces almost anything which is an occupation as distinguished from pleasure, anything which is an occupation or duty which requires attention in business (Town Investment vs. Department of Environment (1977) 1 AII ER 813)
- Business, as contemplated, is an activity carried on with a profit motive , the activity being manual or mercantile, as distinguished from liberal arts or learned profession or agriculture (State of Punjab vs. Bajaj Electrical Ltd. (1968) 70 ITR 730 (SC))
- The continuous repetition of large scale transactions constitutes business. A nexus with the profits of a commercial activity is an essential ingredient of 'business'.

# Taxation of Business Profits

- What constitutes 'Income'?
  - Income not defined in the Tax Treaties
  - Hence, in view of Art 3(20) of the Tax Treaties, we must go back to the National Laws for this purpose.
  - Where an amount is not 'income' and not taxable under the national laws or is exempt wholly/partly, the amount should be taxable in terms of tax treaties on the ground that it represents profit attributable to PE.
  - If the nature of income is such as is not to be taken into chargeability, then, in terms of legal pronouncements or by virtue of the provisions of national laws on account of its being exempt or not otherwise taxables, such amount should be excluded.

# Article 8

## SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
  2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
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1. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
  2. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

# Taxation of Income Air and Shipping Enterprises Engaged in International Traffic

- **Incomes Covered**

Income from carriage of passengers or cargo

This is undue restriction in view of the development of shipping and air transport for practical considerations.

- **Hence**, to cover other classes of income i.e. those which by reason of their nature or their close relationship with profits directly obtained from transport may all be placed under a single category i.e.
  - Profits from leasing a ship or aircraft on charter fully equipped, manned and supplied.
  - Leasing of a ship or aircraft on a bare-boat basis treated as Royalty Income under Art 12 except when it is occasional source of income for the enterprise.

# Air and Shipping Profits

- Sale of passage tickets on behalf of other enterprise
- Operation of bus service connecting a town with airport.
- Advertising and commercial propaganda
- Transporting goods by trucks connecting a depot with a port or airport.
- **Activities Specifically Excluded and to be taxed as business profits under article 7:**
  - A ship building yard operated in one country by a shipping enterprise having its place of effective management in another country.
  - Investment income which is generated by enterprises dealing in international traffic.
  - Keeping of hotels and ship building yard by an air or shipping enterprise.
- **Provision of managing agency and stevedoring services for ships owned and chartered by an enterprise' subsidiaries and affiliates , and for ships owned by third parties** - Only profits derived from services supplied to ships owned or chartered by the enterprise qualifying income from international traffic (Canadian Supreme Court – Furness Withy and Co. vs. MNR)

# PART FOUR

FBR - GIZ Cross Border Transactions and Tax  
Treaties

# Investment Income

- Taxation of Investment Income: Dividends, Interest, Royalties and Technical Fees
  - General Principle of Taxation
  - Arising or source rule?
  - Effectively Connected?
  - Exempt Income
  - Dividends
    - Definition of Dividends
    - Third Country Recipients of Dividends
    - Branch Tax
  - Interest
    - Definition of Interest
    - New Financial Instruments and Their Relevance to Tax Treaties
  - Royalties and Technical Fees
    - Distinction between Royalties, Know-how Fees and Technical Services
    - Computer software – Whether Royalties or otherwise?
    - Typical Methods for Transfer of Technology
  - Capital Gains
    - What constitutes alienation of property?
    - Problems connected with taxation of Capital Gains



# General Principle of Taxation

- Primary Right with Country of residence –  
*Exception US DTA for Royalties, Technical Services*
- Country of Payer has limited Right via withholding Taxes at agreed rates
- Country of Source can charge full taxation where
  - income is attributable to PE/Fixed Base *or*
  - Recipient is not a beneficial owner of income

# Source Rule

- **Dividends**
  - Payer company's country of Residence
- **Interest**
  - Where payer is state/its political sub-division/local authority OR resident of that state – THAT STATE
  - Where interest is borne by a PE/Fixed Base maintained by a person, whether resident or not of that state – THAT STATE
- **Royalties, Know-how Fees and Technical Services**
  - Payers /Recipient's Country
- **Capital Gains**
  - Country where the property is located

# What Constitutes Dividends?

- Jouissance Shares/Rights
- Mining Shares
- Founders Shares or Other Rights  
not being debt claims and participating in profits
- Income from other corporate rights taxed as shares by the laws of state of distributing company

# What Constitutes Interest?

- Income from debit claims of every kind
  - Whether or not secured by mortgage , and
  - Whether or not Carrying right to participate in debtor's profits
- Income from Government securities
- Income from bonds or debentures including attached premiums and prizes
- Income of financial instumrnts like:
  - Options
  - Forward/Futures e.g. Forward /Future Contracts, Future Rate Agreements
  - Swaps : Interest Rate Cap, Repurchase Agreements, Zero Coupon Bonds
  - Straddles, Synthetic Instruments, Hedging, etc.

# Royalties and Technical Services Fees

## Distinction between Patents, Know-how and Technical Services

### Patents

- R & D in Supplier's Enterprise (may) result in production of useful materials, devices, systems and methods, design and development of proto-types and processes which are patented to protect the claimed invention
- Patents are normally restricted in time
- A patent may be assigned to third parties either
  - Sold outright /Out-right Assignment– transferring full ownership and title OR undivided interest without limitation
  - Exclusive Licensed in return for Royalty Payments
- Out right Assignment results in Capital Gains
- Payments for Exclusive License are in the nature of Royalties

# Royalties and Technical Services Fees

## Distinction between Patents, Know-how and Technical Services

### **Know-how**

- Defined as all un-divulged technical information necessary for industrial reproduction of product or processes, directly and under the same conditions, in as much as it is derived from experience.
- Rendered in THREE FORMS(sum-total enabling user to manufacture product):
  - Continuous Flow of Technical Information from Supplier to user enterprise in form of Drawings, Production Guidelines, Computation, etc (continuous basis)
  - Advice and Assistance by Suppliers' personnel at User's place of residence (one time)
  - Instructions to user's personnel in Supplier's Country – Quality Controls, etc. (continuous basis)
- Know-how originates in Supplier's enterprise where concerned product has been made for some time;
- Know-how is the immediate result of R&D
- Technical Assistance in relation to production of certain products – could be
  - very extensive or very modest;
  - Quite independent from or combined with patent license
- Know-how can be assigned by the owner to Third Parties -through a covenant by the Transferor not to use the know-how in future

# Royalties and Technical Services Fees

Distinction between Patents, Know-how Fees and Technical Services

## Technical Services

- Personal Services contrary to Patents, Trade-marks, Designs, etc.
- Where such services are provided in combination with patent and know-how, these fall under Royalties.
- Where such services (including those for engineering, agricultural, scientific, legal, accounting and other professional services) are rendered by persons in their individual capacity or through a juridical person, these constitute ‘Remuneration for Independent Personal Services’.

# Royalties and Technical Services Fees

Distinction between Patents, Know-how Fees and Technical Services

## Management Fees

- Payments for on-going management advice or assistance of a consultative nature in the conduct or supervision of business in general or particular aspect thereof.
- More general in nature relating to Business Growth, Market Potential, Personnel Training, etc.
- Not necessarily associated with technology transfer or with its application
- Generally made by Subsidiaries to Parent Companies for performance of services.
- Often viewed as suspect for transfer of profits in the form of fees.



# Capital Gains

## - Special Features -

- Capital Gains require special tax treatment as in some countries :
  - these are tax exempt where made outside the source of trade or business
  - these are taxed as ordinary income and added to other income
  - these are taxed as a separate block of income at specific tax rate
  - Gains from movable and immovable properties as well as speculative gains are treated differently.
- Treaty Law identifies the tax jurisdiction and leaves the taxation to the treaty countries.
- Special problems may arise in taxation as well as in allowing tax credit where basis for taxation of capital gains is not uniform and taxable amounts do not coincide.

# Capital Gains

## -General Principles of Taxation -

- ❖ Gains in respect of immovable property taxed at its situs.
- ❖ Gains from alienation of movable assets of PE/Fixed Base taxed under Art.7/14
- ❖ Gains from alienation of ships and aircraft taxed in the country of residence of the enterprise.
- ❖ Gains from alienation of shares of real estate companies taxed in country where property is situated.
- ❖ Gains from alienation of shares of a company taxed in its country of residence.
- ❖ Gains from alienation of properties other than those referred above taxed in the state of residence of the alienator.

# PART FIVE

FBR - GIZ Cross Border Transactions and Tax  
Treaties

# PART FIVE

- Taxation of Remuneration for Personal Services
  - Remuneration for Independent Services
  - Remuneration for Dependent Services
  - Directors' Fees
  - Income of Entertainers and Athletes
  - Pensions and Social Security Payments
  - Remuneration of Students and Apprentices
  - Other Income

# Remuneration for Independent Services

- General Principle of Taxation
- What Constitutes Independent Services
- Difference between notion of PE and Fixed Base
- Specific Features of PE
- Specific features of Fixed Base
- Examples

# Remuneration for Independent Services (Continued)

## General Principle of Taxation

- Services must be of independent nature.
- Services Covered:
  - Scientific, literary, artistic, educational services
  - Activities of physicians, lawyers, architects, accountants.
- Right to Tax vests with the country of residence of the professional except where
  - Fixed base is available to him in the other state, or
  - His stay in other state exceeds prescribed period, or
  - Remuneration is paid by a resident of the other state or born by PE or FB in that state and exceeds prescribed amount.
- Only income from activities performed in the other state are taxable therein.
- Income must be distinguishable from Royalties, commercial and industrial profits.
- Commercial and industrial activities and professional services performed in employment excluded.

# Remuneration for Independent Services (Continued)

## Fixed Base?

- Substantially identical to the term PE.
- Taking the conditions of PE as a starting point, Fixed Base requires the following.
  - A Place of Business at a certain location
  - Availability of the place to the Taxpayer; lease not required
  - Use of Place of Business for a duration.
  - Activities conducted through the Place of Business must be covered under the relevant DTA Article.
  - Preparatory or auxiliary activities with respect to the core activities do not constitute Fixed Place.
  - The Place must be instrumental in the performance of activities of professional.
- Notwithstanding the similarities between PE and Fixed Place, these are not interchangeable.
- They refer to different activities and significant differences in time period required to constitute PE or Fixed Place – the later requiring much shorter period

# Remuneration for Dependent Services

- Covers remunerations of employees of private enterprises.
- Primary Right to Tax vests with country of residence.
- Source country may tax such income where
  - Employees' stay in the other state exceeds prescribed period, or
  - Remuneration borne by or on behalf of a non-resident employer., or
  - Remuneration not borne by PE / FB which the employer has in the other state.
- 'Period of stay' encompasses only 'Days of Physical Presence'; Days in Transit, Holidays, Short Breaks spent outside the 'State of Activity' excluded.
- Remuneration of ships/aircraft crew operating in international traffic taxable in the country of Residence/Effective Management of the enterprise concerned.
- Deferred Salary Taxation: Where it relates to the period was resident of a state was employed in the other state, deferred salary would also be taxed in the other state.



# Directors' Fees

- Remunerations of a person (individual or legal person) in his capacity as member of Board of Directors of a company taxable in the country of its residence.
- Directors vs. Top Officials – The Executive Directors' Fees are also taxable in the country of residence of the company.

# Income of Entertainers and Athletes

- Visiting artists and professional athletes (including *artiste companies*) are subject to full source taxation.
- Residence, or period of stay irrelevant in assigning source country taxation.
- Some DTAs tend to provide monetary limit for source taxation.
- No precise definition of Artists and Sportsmen.
  - By way of illustration: a theater, motion picture, radio or TV artist or musician covered.
  - Sportsman, not restricted to traditional athletic events; covers golfers, jockeys, footballers, cricketers, tennis players, race drivers, etc.
  - Freelance models earning from modeling activities not covered.
- Visiting conference speakers, administrative and support staff (e.g. cameraman, producers and film directors, choreographers, etc.) excluded.

## Pensions and Social Security Payments

- Internationally following alternative approaches are followed:
  - Exclusive taxation to country of residence of recipient.
  - Sharing of taxes between the residence and source country where payments are not made within the framework of social security scheme of a state.
- Remunerations and pensions in respect of government services for performance of government functions exclusively taxable by the Payer State
- Functions of Governmental Nature not defined, but includes executive, legislative and judicial functions.

## Other Income

- Income other than specifically covered in other DTA Articles falls with 'Other Income' e.g. disability pensions, gambling winnings, lotteries, etc.
- DTA provisions operate in conjunction with Art. Relating to concept of Residence.
- Depending on the provision of a particular DTA, other income may be taxable in the residence or source state.
- Where other income is derived from a property or right effectively connected with PE or FB in a state, it is taxable therein.