Double Tax Treaties ("DTT")

With more than 3,000 tax treaties in force around the world, tax treaties represent the cornerstone of the international tax regime. A tax treaty, also referred to as a "convention" or "agreement," is a binding legal agreement between two or more sovereign territorial jurisdictions to provide relief or benefits to the residents/nationals of the treaty signatory jurisdictions (usually countries, but sometimes a specific territorial part of a larger country, such as Hong Kong).

The main goal of tax treaty is to facilitate cross-border trade and investment by limiting tax impediments to the movement of capital and individuals. One main objective is the elimination of double taxation, which is accomplished by allocating taxing rights among signing countries by exclusivity, priority, or limited priority. In addition, double tax relief is achieved by providing a credit against domestic taxes for foreign tax paid to another contracting jurisdiction. In situations where the tax credit benefit may not be appropriate, a deduction of the foreign tax paid can be provided by domestic law or treaty. The main principle of a double tax treaty is to ensure that income is taxed once, and only once.

An ancillary goal of a tax treaty is to eliminate tax avoidance and tax evasion, which is generally achieved by the exchange of information. Tax treaties include such requirements and, more recently, specific Tax and Information Exchange Agreements ("TIEA") have been established with low or no income tax jurisdictions to provide for the exchange of tax information on residents with financial account(s) abroad.

The exchange of information is the Organisation for Economic Co-operation and Development's ("OECD") preferred way to deter tax evasion and tax abuse – through the implementation of international norms, namely the Common Reporting Standards ("CRS"). The CRS provide a channel for participating countries to automatically communicate (and receive) financial information about foreign individuals to the tax authorities of their country of residence. Following the Base Erosion Profit Shifting ("BEPS") project, new tax reporting standards for multinational enterprises have arisen, including more detailed internal transfer pricing assessments. These OECD initiatives attempt to provide a more transparent international tax regime, however, it is important to note that the U.S. is not signing party to the CRS. The U.S. FATCA provisions are comparable to the CRS, consequently, the U.S. receives information on its citizens through FATCA, but the U.S. does not provide a reciprocal disclosure on foreign account holders as would be provided under the CRS.

Tax treaties also contain provisions to provide fairness and efficiency in tax administration, including non-discrimination, administrative process, and tax collection provisions.

History of DTT

The first tax treaties focussed on determining the right of one state (over another) to exclusively tax a specific income source. The historical concepts of taxing rights were based on the residence of a taxpayer, or the source of an income, and still form the underlying basic principles of tax treaties. Specifically, it is a general rule that capital is taxed in the country of residence of an investor (except for real property), and income is first taxed in the country where it is sourced.

Structure of DTTs

As noted previously, the main goal of double tax treaties is to remove obstacles to the mobility of capital and individuals in order to ease commerce and trade among nations. Some provisions are exclusively designed to apply to individuals, some to enterprises, and others apply equally to both.

Common tax treaty provisions

As in any legal document, there are provisions that define or limit the scope of application. First, the treaty will establish the territorial application where benefit of the treaty can be claimed. Then there is a description of what legislation is covered by the treaty. Finally, the treaty defines the legal subject (i.e., individual or legal entities), can claim treaty benefit or protection.

Common sections that address individuals relate to dependent or independent services, employment, individual residency, director's fees, artists and sportsmen, pensions, inheritances, public services and students.

Common sections that are exclusively concerned with enterprises define the concept of "permanent establishment," business profits, multinational enterprises, and services of shipping, waterways and air transport.

The sections that allocate taxing rights over income sources such as interests, dividends, royalties or other income, and capital gains (including gains and income from real property), are linked to the source concept – not to a taxpayer – therefore, the type of (income) recipient is irrelevant. However, a recipient with a substantial ownership interest in the payor corporation can typically claim a further reduction in the withholding tax rate for dividends.

Other common provisions address foreign tax credits (or deductions), non-discrimination, exchange of information, assistance in tax collection, diplomatic and consular personnel and the mutual agreement procedures.

Main treaty models

The OECD Model

This Model is designed to provide relief from tax barriers to cross-border trade and investment. It is frequently the basis for negotiation and application of bilateral tax treaties between countries, and designed to promote business while helping to prevent tax evasion and avoidance. The OECD Model also provides a uniform basis for the most common problems that arise in the field of international double taxation and is the most widely used model convention.

The most recent revision of the OECD Model Tax Treaty was in December 2017, to reflect the integration of certain measures from the Base Erosion Profit Shifting ("BEPS") project action plan.

The OECD measures are substantially integrated into the updated Canada-U.S. tax treaty that came into force in January 2009.

UN Models

The OECD Model convention was designed with developed countries of comparable economy in mind. On the other hand, the UN Tax Treaty Model addresses situations where developed countries seek to reach a tax treaty with developing countries. Under the UN Model, the concept of "source of income" is more important, as it provides more tax revenue to the developing country. In addition, the concept of "permanent establishment" is less restrictive to allow taxing rights to the source country, instead of the residence of the enterprise doing business in a foreign country.

The UN Model was also recently revised in 2018 to reflect the OECD action plan from the BEPS project.

U.S. Model

The U.S. Model differs from the OECD and the UN Models since the U.S. is the only country to have a tax regime that taxes its citizens (and long-term green card holders) regardless of where they live. Most other countries retain the concept of residence to impose tax.

Using citizenship as a main basis of taxation requires relief to be provided to citizens living abroad, specifically tax relief for foreign tax paid by a U.S. citizen. Therefore, specific provisions address this issue by protecting the taxing rights of the U.S. through a "saving clause."

The U.S. has been an ardent promoter of the "Limitation of Benefits" provisions, which restrict the benefit of the treaty convention to only those beneficiaries that are true residents of the treaty country. It accomplishes this by attempting to restrict access to tax treaty benefits where foreign entities are structured solely to access entitlement to the treaty benefits (treaty shopping). The U.S. Model was the first to include such a provision.

The most recent U.S. Model Tax Treaty was published in February 2017. It provides technical updates to the 2006 Model but contains no substantial changes. However, the U.S. Tax Cut and Job Act adopted in December 2017, introduced substantial changes to the taxation of U.S. foreign-controlled corporations. These recent changes have lead many tax practitioners to believe that the U.S. Model convention may soon be revised.

Multilateral instrument

New to the international tax world is the Multilateral Instrument ("MLI"). It may be a turning point in the future of tax treaty negotiations. Following the BEPS project, there was a need to renegotiate multiple bilateral tax treaties to incorporate the new provisions. The MLI allows jurisdictions

to swiftly implement the new measures proposed, which eases the process of modifying existing tax treaties. Participant countries now have a tool to ensure their tax treaties are automatically modified as required.

The signatories to the MLI may choose which existing bilateral tax treaties they would like to modify using the MLI. Once a tax treaty has been listed by the both parties, it becomes an agreement to be covered by the MLI and automatically modifies the specific tax treaty.

The current signatories have listed over 2,500 treaties, leading up to over 1,200 matched agreements. Going forward, the number of modified tax treaties is expected to increase. The BEPS MLI came into force on July 1, 2018.

The introduction of the MLI marks a departure from multiple bilateral negotiations, which were traditionally required to modify numerous bilateral treaties.

Summary

As outlined above, most tax treaties seek to facilitate cross-border trade and investment, and eliminate double taxation. As a result, most treaties have a similar structure. However, many treaties also contain different solutions and rates depending on the relationship between each signing country. As such, it is critical to consult the latest version of a treaty to understand the specific provisions that apply to each particular situation.

For more information, please speak with your BMO Private Wealth professional.

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