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Double non-taxation

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1. Policy questions

The Czech Republic has up to now concluded 66 bilateral double taxation agreements in the area of income and capital. There are also two multilateral treaties concluded between former member states of the "socialist block"; however, they are nowadays rarely used as in most cases they have been replaced by modern bilateral tax treaties. Therefore in this report I will not take them into account.

Those 66 bilateral tax treaties generally follow the OECD model. There is no officially published national model; however, we can say that the Ministry of Finance has its "working" model text, which reflects the interests of Czech treaty policy. The Czech model follows the OECD model, but departs from it in certain respects that were expressed in the form of reservations made by the Czech Republic at the OECD forum and included in the model (mainly article 5 – wider definition of permanent establishment, article 12, coverage of payments for use or right to use scientific, commercial or industrial equipment, and some others). The Ministry of Finance has been observing the recent changes of the OECD model treaty and keeps the public informed. However, the treaties recently concluded do not yet reflect these changes, because the negotiations started some time before 2002.

The Czech Republic has preferred the credit method in its tax treaties since 1993. So 43 treaties concluded in and after this year have incorporated only the credit method for the elimination of double taxation. The treaties concluded in the 1970s and 1980s incorporate both methods – the credit method generally for dividends, interest, royalties, income of artists and sportsmen, and the exemption method for other types of income inclusive, mainly employment income and business income. Limitation to the credit method only is an expression of an endeavour to prevent double non-taxation. On the level of domestic legislation it can be seen for years that there has not been a general agreement on common

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policy in this area as a corollary of the fact that the legal preparation of tax treaties and the legal preparation of income tax laws are dealt with by different departments at the Ministry of Finance and their work in the international field is not satisfactorily coordinated. Nor is the national model subject to wider discussion within general income tax policy.

This can be documented in the history of domestic provisions concerning elimination of double taxation. From 1993 to 1995 only the credit method was available. In 1995 the exemption method was added for cases of foreign employment and according to the interpretation of the Ministry of Finance the exemption method could also have been used in cases where the particular double tax treaty included only the credit method. In 2001 both methods – credit and exemption – were abolished in domestic legislation, so since then double taxation can be eliminated solely on the basis of double tax treaties. Income from non-treaty countries is taxed twice, though double taxation is mitigated by means of the deduction method. In autumn 2003 a new amendment to the Income Taxes Act was submitted to Parliament. This amendment does not change this approach; however, it brings an innovation. The methods used under tax treaties (exemption and credit methods) are for the first time in the history of the law described and the computations are explained. The law also newly includes a specific subject-to-tax clause.

So far the national model does not include any subject-to-tax clauses and none of the currently valid treaties includes such a provision or a similar one. If some countries focus on the prevention of double non-taxation, the same is not true for the Czech Republic. However, the concentration exclusively on the credit method can be seen as a step towards prevention of double non-taxation, as the credit method eliminates actual double taxation while the exemption method eliminates potential double taxation. Therefore when the Czech Republic renegotiates older treaties it introduces the credit method without any exception (see the new treaties with Belgium, Canada, France). However, this cannot be seen as an object of the treaty policy. What is contrary to such an objective is that in the past the Czech Republic was quite willing to include in its tax treaties a tax-sparing clause if the partner country wished to. It is not a Czech preference and I think the Czech Republic does not offer it itself. Such a clause may be found in 18 treaties (to name the European ones: Albania, Cyprus, Denmark, Greece, Latvia, Lithuania, Malta, Poland, Slovakia). It seems that the Czech Republic will depart from this approach, which can be seen from the renegotiated treaty with Slovakia, which no longer contains this provision.

There has been a discussion for several years on harmful tax competition between OECD and EU countries. I think this has not been an issue for the Czech Republic. The Czech Republic started to be interested in this issue only in respect of accession to the EU. The Code of Conduct group reviewed tax measures which could be considered as tax harmful in the EU candidate countries. It is still a matter of evaluation how the Code of Conduct group will evaluate investment incentive measures in the Czech Republic. Matters of double non-taxation, which can occur based on the application of domestic law or of double tax treaties are in our view a marginal issue and are mostly unintentional. They cannot have a great impact on the decision of companies as to where to locate their businesses and

therefore could not be considered as harmful within the meaning of the Code of Conduct.

As mentioned above, the latest amendment to the Income Taxes Act has a subject-to-tax clause; however, it refers to "income subject to tax according to tax treaties", and because the treaties do not incorporate such provisions, the domestic provision will not prevent double non-taxation situations. The law also includes a deduction method, which is basically a "subject-to-tax" provision, because only actually paid tax may be deducted from the tax base. However, this provision is relevant only in non-tax treaty situations and in situations of deduction of excess credit.

2. Avoiding non-taxation by applying tax treaties simultaneously with the existing OECD model treaty

2.1. Object and purpose of double tax treaties

The object and purpose of double tax treaties is stipulated in the title of the treaty: for the avoidance of double taxation. In a few treaties the Czech Republic and its counterpart stipulated that the treaty was concluded also with the aim of preventing fiscal evasion. Fiscal evasion is an illegal act where an intention of the taxpayer to decrease his tax liability must be proved. Double non-taxation occurs as a side effect of the application of a method of elimination of double taxation, which the taxpayer even might not intend, or else he knows about this effect and intentionally takes advantage of this possibility. However, this could in no case be regarded as fiscal evasion but is rather tax avoidance within the borders of the law. Therefore the authorities accept such results and no case has been brought before the court by any tax authority, contesting that it is a misuse of a tax treaty. Though on a theoretical level tax authorities, taxpayers and courts would agree that the application of tax treaties should not lead to double non-taxation, this is not perceived as an object of the treaty. Moreover the courts rather rely on a literal interpretation of the treaties rather than a teleological one. So they accept non-taxation as a legitimate result of treaty applications. Double non-taxation happens, e.g. in the area of foreign employment, where the taxpayer may be taxed in the source country but for whatever reason in fact is not taxed there, and the Czech Republic exempts the income according to a tax treaty. The reason for that might be fact that the source country does not know that the taxpayer has income from other sources. In addition, when using the exemption method in the Czech Republic the taxpayer is not obliged to prove that his income was actually paid in the source country.

2.2. Liable to tax

A tax treaty may only be applied if the taxpayer is a resident within the meaning of article 4, paragraph 1 of the OECD model. The crucial issue there is the term

"liable to tax"; however, the treaty refers to domestic legislation. The OECD *Report on Partnerships* suggests that residents have to be "liable to tax on their share of the partnership income". As regards interpretation by the Czech authorities of this term, there is none.

The treaties refer to domestic criteria used for determination of tax residency. The Czech Income Taxes Act does not use the terms "tax resident" and "tax non-resident". It defines the taxpayer of individual income tax and the taxpayer of corporate income tax and determines their tax liability. So there is a taxpayer who has shortly speaking a limited tax liability (non-resident) and a taxpayer who has an unlimited tax liability (resident). The decisive criteria for determination of tax residency are for individuals residence and habitual abode (more than 183 days in a calendar year) in the Czech Republic, and for the taxpayer of corporate income tax the seat and the place of management in the Czech Republic. The taxpayer of corporate income tax is any entity which is not a taxpayer of individual income tax and also organizational units of state, so it cannot happen that an entity does not fall under one or the other category. The only entity which is explicitly excluded from being a taxpayer of corporate income tax is the Czech National Bank. So also partnerships (*veřejná obchodní společnost*), which are under the Czech commercial law legal entities, fall within this broad definition. We can thus conclude that based on a domestic definition they are tax residents – taxpayers of corporate income tax, though they are taxed transparently and actually do not pay tax.

The question then is raised whether tax residents under domestic legislation are considered tax resident also within the meaning of article 4(1) of the treaties. As said above, there is no official interpretation from the Ministry of Finance of the term "liable to tax", so there are differing opinions on this issue. However the Ministry of Finance included in the OECD *Partnership Report* a clear opinion that partnerships are not considered residents within the meaning of tax treaties and therefore they cannot receive treaty benefits; the partners should claim them instead. However, the opinion is mute as regards limited partnerships (*komanditní společnost*), where the company is also taxed transparently as regards the part of the unlimited partner.

As described above, all entities will fall within one or another definition of tax resident, even not-for-profit organizations, or companies which receive investment incentives, or entities which are in a loss position. The residency is judged against the background of the criteria mentioned, and no such facts as exemption from taxation, loss position, income less than the tax-free amount are taken into account. The tax authority will not deal with the interpretation of the treaty term "liable to tax" and will issue a residence certificate based on those domestic criteria.

If a dual resident company has a seat in the Czech Republic and a place of management abroad, it qualifies as a resident of the Czech Republic domestically but based on the tie-breaker rule in a double tax treaty, it is regarded as non-resident in relation to the particular country. Therefore if it has income only from sources from the place of management country, it is not subject to taxation in the

Czech Republic. However, income from third countries should be included in their worldwide tax base, as in respect of third countries such a company remains a tax resident in the Czech Republic.

2.3. Certificates of non-residents

The Czech Republic employs an automatic system of application of benefits according to treaties. This means that the burden of proof lies on the payer of the income. He has to ascertain whether the recipient of the income is a tax resident of a particular country. The law does not impose any obligation on him to collect a certificate of residence from the foreign recipient. There is only a by-law instruction saying that he is liable to have the certificate if he is in doubt about the recipient's residence. In practice companies at the time of income payment sometimes have the certificates, sometimes not. The adverse result of not having the certificate may emerge only when a tax authority opens a tax audit with the payer of the income and ascertains whether the international treaty was applied properly. In that case they require certificates of residence as a proof and are not satisfied with any other documents or proofs, although the law does not include such a requirement.

The issue of whether the authorities refuse to grant benefits when the foreign taxpayer does not submit a certificate is not relevant in the case of the Czech Republic, because as mentioned the tax authority is not involved in the process of automatic application of the treaties. However, if the payer of the income does not apply this automatic approach, the foreign taxpayer may ask the tax authority for the refund. In that case it is recommended that the application includes a certificate, otherwise the tax authority will refuse the tax benefits, although there is no legal requirement to submit this certificate. There are cases when a tax authority has refused to do this, when a US taxpayer was not able to submit a certificate. They refused to accept any other proofs or documents.

2.4. Certificates for residents

Tax authorities issue certificates of residence to Czech tax residents and, as already mentioned above, they take into account only domestic criteria and do not judge whether the taxpayer actually paid the tax. As the domestic definition of residency does not refer to actual taxation they are not in a position to refuse to issue the certificate to exempt entities or entities which are in a loss position, etc. It can be expected that they would also issue such a certificate to partnerships, because domestically they are tax residents and they are not sufficiently educated in international issues and do not know the OECD *Partnership Report*, where the Czech Ministry of Finance stated that partnerships should not be entitled to treaty benefits as they are transparent entities. In case of branches of foreign entities the Czech authorities should not issue a certificate to them. However, I know about at least one case when a Prague local authority issued a certificate to a Czech branch of German bank for the purpose of receiving interest from a third state.

2.5. Beneficial ownership concept

Czech tax law does not recognize the concept of beneficial ownership. This concept is found in a majority of Czech tax treaties, but in some older ones it is missing as they were concluded according to the older model. Though the commentary interprets that even in older treaties this concept should be respected though it is missing there, the experience in the Czech Republic is that the treaty is interpreted literally and therefore where the concept is not included the taxpayers "take advantage" of it. The tax authorities seem to accept this approach. Moreover in many cases they have not sufficient experience and means to verify whether the recipient is the beneficial owner.

The Ministry of Finance made a first step to elucidating this concept to the tax authorities and the public in their by-law instruction concerning the explanation of the concept. This explanation emanates from the OECD commentary. As the concept appears only in articles 10–12 of the treaties it could not be used in other areas of taxation as a means of preventing double non-taxation.

2.6. Prevention of double taxation under 23/1

There are no indications that the Czech tax authorities will adopt a new approach suggested by the commentary, that if the source country does not tax the item of income for any reason, the residence country should interpret that the income "may not be taxed" and therefore will not give a relief from double taxation. Again the authorities would interpret the phrase "may be taxed" literally and would not take into account whether the source country had made use of its right to levy and collect the tax.

In my opinion it could be relevant whether double non-taxation is the result of differences in domestic law or of different interpretations of a tax treaty provision. In the first case the Czech authorities would tend to respect the way in which the other country, which applies the treaty, interprets concepts not defined in the treaty. Thus the incidence of double non-taxation may be reduced in such cases. The latter case – conflict in treaty interpretation – is a different issue. In such a case there should be some mutual agreement between the treaty partners in order to avoid double non-taxation. So far there are no examples of such reasoned procedures.

2.7. Avoiding non-taxation by applying article 23, paragraph 4 OECD model

The OECD Committee on Fiscal Affairs added a paragraph 4 to article 23A of the OECD model:

> "The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income."

This new paragraph has not been added to any recently concluded treaties. Since the Czech Republic includes exclusively the credit method in its tax treaties it can be supposed that this provision will not be added in the future either.

2.8. Avoiding non-taxation by applying specific bilateral provisions

As mentioned already under the discussion of policy issues, Czech double tax treaties do not contain a "subject to tax clause", or similar provisions.

Résumé

En général, à l'exception de certaines dérogations indiquées dans les réserves qui accompagnent le modèle, la République tchèque suit le modèle de l'OCDE pour négocier ses conventions de double imposition. La prévention de la double non-imposition n'est pas considérée comme l'un des objectifs de la politique fiscale actuelle.

La méthode préférée de la République tchèque en vue d'éliminer la double imposition est la méthode de l'imputation, qui réduit considérablement l'incidence de la double non-imposition.

D'une manière générale, la double non-imposition ne peut pas être évitée sur la base des conventions de double imposition étant donné qu'elles ne contiennent pas expressément une clause d'"assujettissement à l'impôt". Selon une information officieuse, le ministère des Finances envisage d'inclure à l'avenir cette disposition dans le modèle national.

Zusammenfassung

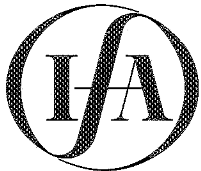
Die Tschechische Republik folgt bei Verhandlungen ihrer Doppelbesteuerungsabkommen im Grossen und Ganzen dem OECD-Musterabkommen, mit Ausnahme bestimmter Abweichungen, die bereits als Vorbehalt gegen das Musterabkommen vorgebracht wurden. Die Vermeidung der doppelten Nichtbesteuerung ist gegenwärtig nicht Ziel der Abkommensbestimmungen.

Tschechiens bevorzugte Methode zur Vermeidung der doppelten Nichtbesteuerung ist die Anrechnungsmethode.

Im Allgemeinen können Doppelbesteuerungsabkommen eine doppelte Nichtbesteuerung nicht verhindern, denn diese beinhalten keine Besteuerungsklauseln. Laut inoffizieller Informationen beabsichtigt das Finanzministerium, künftig eine solche Bestimmung in das nationale Modell aufzunehmen.

Resumen

En general, excepción hecha de determinadas derogaciones incluidas en las reservas que lo acompañan, la República Checa sigue el modelo de la OCDE en sus negociaciones de los convenios de doble imposición (CDI). No se considera objetivo de la actual política fiscal la prevención de la doble imposición.



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La República Checa aplica preferentemente el método de la imputación para eliminar la doble imposición, que reduce considerablemente la incidencia de la doble no imposición (DNI).

En general, la DNI basada en los CDI no puede prevenirse porque no contienen cláusula expresa de “sujeción a tributación”. Según fuentes no oficiales, el Ministerio de Hacienda estudia incluir esta disposición en el modelo nacional en un futuro próximo.