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Double tax agreements

Double tax agreements, double tax treaties or, in short, DTAs represent a complex area in the field of international tax. Therefore this article does not purport to comprehensively cover the topic; it merely aims to provide a high-level overview of DTAs, with a special focus on the concept of 'permanent establishment'. This article will focus on the main features and explain some common terms and catchphrases used in connection with treaties – further in-depth detail will not be included.

What is a DTA?

As the name suggests, a double tax agreement is an agreement or a contract regarding double taxation or, more correctly, the avoidance of double taxation. In the Malaysian context, a DTA is usually signed by a cabinet minister (or sometimes by the prime minister) representing his country. Thus, it is an agreement between two sovereign states (separate and distinct political entities). It has the status of a 'treaty' – hence, its alternative name of double tax treaty.

A DTA is therefore a contract signed by two countries (referred to as the contracting states) to avoid or alleviate (minimise) territorial double taxation of the same income by the two countries. Any amendment or addition to such an agreement is known as 'a protocol'.

How territorial double taxation occurs

When residents (be they individuals, corporations or enterprises) of any two given countries trade or transact commercially with each other, it gives rise to international trade, or cross-border transactions.

Illustration 1

A typical scenario is when A, a person based in Country A, transacts business with a person resident in the other country, Country B. The profits or gains thus accruing to A is, say, \$100. This \$100 is likely to be subject to tax in Country A (because he is resident or based in Country A), as well as in Country B (because the gains are derived or sourced from Country B).

Thus, the same income item of \$100 is subject to territorial double taxation, once in Country A, then again in Country B.

Assuming Country A has a tax rate of 30%, while Country B taxes the income at 25%, A will potentially suffer a global tax of $55 [(30%of $100) + (25% of $100)], leaving him with a measly after-tax income of only $45.

Why have DTAs?
Territorial double taxation obviously discourages international trade. A trader is better off trading within the state boundaries and suffer tax in one country only. However, it is a widely accepted commercial reality that international trade is economically good for the countries concerned, and that international trade should be encouraged. Thus, countries believing in the benefits of international trade would try to provide a more conducive environment for cross-border trade by putting down rules to avoid or minimise double taxation.

This leads to the need for countries to bilaterally and mutually agree to specific terms and rules of how income or profits of international trade or cross-border transactions are to be treated by the two countries so that the final tax suffered will not be worse off than if the profits or gains are derived from similar non-cross-border transactions.

So, it is a typical development for two countries to enter into a DTA if the volume of trade or commercial activities is expected to increase. You may have read in the newspapers about a minister visiting another country or vice versa, announcing that they would like to see more trade between the two countries. This signifies that a DTA has been – or will soon be – signed.

What's in a DTA?
A typical DTA will contain 'articles' (ie chapters or parts) covering various areas. When a DTA is mooted, the two countries will start off with a model convention, which is a template containing the standard articles and clauses of a DTA. Each country will come to the negotiating table with its list of conditions or 'must-haves'. The treaty that is ultimately signed is therefore the culmination of rounds of negotiations, compromises and trade-offs. This is the reason why every treaty is unique and the particular treaty must be referred to whenever an issue arises pertaining to the two countries. The OECD (Organisation for Economic Co-operation and Development) model convention is one of three main ones; the other two are the UN (United Nations) and the US model conventions.

Although Malaysia is not a member of the OECD, it largely adopts the OECD model convention with a few features borrowed from the UN model convention for the DTAs hitherto signed.

The standard articles of a model DTA are as follows:

Title and Preamble

Chapter I: Scope
Article 1 Persons covered
Article 2 Taxes covered

Chapter II: Definitions
Article 3 General definitions
Article 4 Resident
Article 5 **Permanent establishment**

Chapter III: Taxation of income
Article 6 Income from immovable property
Article 7 **Business profits**
Article 8 Shipping, inland waterways transport and air transport
Article 9 Associated enterprises
Article 10 Dividends
Article 11 Interest
Article 12 Royalties
Article 13 Capital gains
Article 14 Technical fees (Note: This is an adaptation in Malaysian treaties)
Article 15 Income from employment
Article 16 Directors' fees
Article 17 Artistes and sportsmen
Article 18 Pensions
Article 19 Government service
Article 20 Students
Article 21 Other income

Chapter IV: Taxation of capital
Article 22 Capital

Chapter V: Methods for elimination of double taxation
Article 23A Exemption method
Article 23B Credit method

Chapter VI: Special provisions
Article 24 Non-discrimination
Article 25 Mutual agreement procedure
Article 26 Exchange of information
Article 27 Assistance in the collection of taxes
Article 28 Members of diplomatic missions and consular posts
Article 29 Territorial extension

Chapter VII: Final provisions
Article 30 Entry into force
Article 31 Termination

Comments on some articles

Here are some comments on the articles that are more often referred to.

Scope and treaty benefits

Article 1 specifies the scope of the treaty: that only residents of one or both countries (the contracting states) are covered by the treaty. This is important as only the qualifying persons may avail themselves of treaty benefits such as exclusion from tax, tax exemption, preferential tax rates, double tax relief, and so on.

Dual residence

With the greater physical or geographical mobility enabled by cheaper and frequent air travel and greater connectivity through the internet, companies and individuals may find themselves fulfilling residency requirements in more than one country for the same fiscal year. Thus arises dual residency.

Illustration 2
For instance, in 2012, an individual normally resident in Country A may travel regularly to Country B on business and/or leisure, such that he is considered a tax resident of both Country A and Country B for the fiscal year of 2012. He is therefore in a dual residence situation.

Article 4 'Resident' has set rules called the tie-breaker rules to resolve dual residence for purposes of the application of treaty clauses. The outcome will be that the individual will be deemed to be resident in one of the countries for treaty purposes.

Permanent establishment and business income

This is an important area. Two whole articles are devoted to it: Article 5 for 'Permanent establishment', and Article 7 for 'Business income'.

For a resident of one contracting state, what constitutes a 'permanent establishment' (PE) in the other contracting state is dealt with at length. Detailed rules help to establish whether there is a PE or otherwise.

The fundamental principle for a DTA is that for business income, a person (whether an individual or a company) from one country (Country A) will be taxable in the other country (Country B) only if he has a PE in Country B.

If there is a PE, only the income attributable to such PE in Country B will be subject to tax in Country B.

A more detailed discussion of PE is featured later in this article.

Dividend, royalty, interest and other sources of income
Apart from business income, Articles 6, 8–21 govern the respective taxing rights for the country of residence and the country of source, the scope and tax rates (usually reduced under the treaty) for the non-business sources of income.

Illustration 3
For example, if a German resident receives royalties sourced from Malaysia, the domestic tax rate (under the Income Tax Act 1967) for royalty received by a non-resident is 10% of gross. Under Article 12 of the Malaysia-Germany treaty (signed in 2010 and effective from 2011), royalties received from Malaysia by a German resident is subject to tax at only 7%. This is one of the several 'treaty benefits' available under the said DTA.

Double tax relief
The over-riding objective of a DTA is the avoidance or minimisation of double taxation. This is achieved mainly by the granting of double tax relief by the country of residence.

Illustration 4
Based on the above-mentioned scenario of the $100 profit made from cross-border trade and subject to double taxation, if there is a DTA signed between the two countries and the credit method is adopted for the elimination of double taxation, the double tax relief mechanism would work as follows:

	$	**$**	**$**
In Country A (country of residence)			
Income		100	
Country A tax at 30%	30		
Less double tax relief –			
ie Country B tax at 25%	(25)		
Tax payable in Country A			5
In Country B (country of source)			
Income		100	
Country B tax at 25%			25
Total tax payable globally			**30**

Double taxation is thus avoided; instead of paying tax of $55, person A pays only $30 globally on the profit of $100. Note how the two countries agree to share the tax revenue, and how the country of residence gives the credit (ie foregoes the tax revenue) of $25 to eliminate the double taxation.

Treaty overrides domestic laws

Section 132 provides that if a DTA has been entered into and it has started to take effect, then, so long as the DTA remains in force, the DTA

> '...shall have effect in relation to tax under this Act **notwithstanding anything in any written law.**'

Thus, DTAs supersede 'any written law' – ie not just tax laws.

This principle has been repeatedly followed and reinforced by the courts; it says that if there is a conflict between domestic law (tax laws, labour laws, etc) and the treaties, the treaties will prevail. Thus, if a treaty provision accords exclusion from tax, any domestic law that imposes tax must give way to treaty provision and surrender its right to tax.

A shield, not a sword

Another principle that has been supported in judicial decisions is that a DTA exists to avoid double taxation, not to impose tax, if there is no such tax liability under domestic law. Essentially, the domestic law in the form of the Income Tax Act 1967 is the one and only law to impose a tax liability. A DTA can only act as a shield against double taxation; it cannot wield the taxation sword because it has no authority to do so.

Treaty shopping

This term refers to the practice of searching for (hence the 'shopping' element) a suitable country to locate a company in and then placing the said company in that country mainly to take advantage of the treaty benefits accorded to its residents. If such a company is merely a 'conduit' structure and does not have sufficient 'substance' (ie real and actual commercial activities being carried out by such a company), it may come under scrutiny by the relevant tax authorities and treaty benefits may be denied as a result.

Permanent establishments and business profits

Having dealt with general aspects, let us now examine the very important and pivotal concept of PE in more detail, and consider the significance of a person or enterprise having a PE in a foreign country.

Fixed place of business

PE is a concept in double tax agreements which means 'a fixed place of business through which the business of an enterprise is wholly or partly carried on.'

The important elements of a PE are therefore:

- a place of business – there must exist a facility such as premises, facilities or installations and, in some instances, machinery or equipment. It may mean a space which is at its constant disposal
- fixed – the place of business must be fixed, ie it is a distinct place with a degree of permanence. Note, however, that there need not be any formal legal right to use a particular place or space
- through which the business of an enterprise is carried on wholly or partly – this means that persons who are dependent on the enterprise, or persons who represent the enterprise, conduct the business of the enterprise through this fixed place of business.

Fixed base: positive list

A DTA usually provides a list of examples of fixed base. The list is indicative, therefore not exhaustive. Each item is to be seen against the background of the general meaning of a 'fixed base' discussed above. The positive list usually features the following:

- a place of management
- a branch
- an office
- a factory
- a workshop, and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Building site or construction or installation project

On the face of it, a building site, or a construction/installation project constitutes a fixed place of business. However, such a site or project must last a certain minimum period before it can be regarded as a PE. The minimum period prescribed may be six months, nine months or 12 months, depending on what is mutually agreed by the two contracting states. In many of the treaties entered into by Malaysia, six months is the minimum period, although there are some stipulating nine months or even 12 months.

Do bear in mind that the shorter the period stipulated, the easier it is to constitute a PE.

Illustration 5

A German company has secured a project to install 50 wind turbines in Malaysia within a five-month period. It is unlikely to establish a PE through this installation project alone because the Malaysia-Germany treaty stipulates a minimum period of nine months.

Negative list
A treaty will also provide a negative list – ie certain activities of a preparatory or auxiliary character will *not* constitute a PE. The term PE shall not include the following:

(a) The use of facilities solely for storage, display or delivery of goods/merchandise belonging to the enterprise.
(b) The maintenance of a stock of goods/merchandise solely for storage, display or delivery.
(c) The maintenance of a stock of goods/merchandise solely for processing by another enterprise.
(d) Maintaining a fixed place of business solely for purchasing or collection of information for the enterprise.
(e) Maintaining a fixed place of business solely for the carrying out any other activity of preparatory or auxiliary character.
(f) Maintaining a fixed place of business solely for any combination of activities mentioned in (a) to (e), provided that the overall activity resulting from such combination is preparatory or auxiliary in character.

This means that if all an enterprise does in the other country is purchase, store, deliver, or collect information, or any combination of these activities, the enterprise is deemed to have carried out activities that are merely preparatory or auxiliary in character. The enterprise will not establish a PE purely by carrying out such activities.

Agency PE
Where an enterprise has, in the other country, a person:

- who regularly acts on its behalf, and
- who is vested with authority to conclude contracts in the name of the enterprise, and
- who habitually exercises such authority,

the enterprise is deemed to have a PE in the other country.

Such a person may be an employee or a dependent agent – ie he is *not* an independent agent acting in the ordinary course of his business.

Illustration 6
A Malaysian export company has a representative based in Singapore who would regularly take instructions from Malaysia, reports to Malaysia, and who enters into sales contracts on behalf of the Malaysian company. The representative renders these services exclusively to the Malaysian company and is remunerated by the Malaysian company.

The Malaysian company is deemed to have a PE in Singapore because of the presence of the representative in Singapore who regularly transacts on behalf of the Malaysian company.

It follows, therefore, that an enterprise shall not be deemed to have a PE merely because the enterprise carries on business in the other country through a broker, general commission agent or any other independent agent acting in the ordinary course of their business.

Illustration 7
A Singapore investment-dealing company regularly buys and sell shares on the Bursa Malaysia. All the transactions are carried out by a stock broker operating in Kuala Lumpur based on instructions received from the Singapore company. The stockbroker is an independent agent: his business is to trade shares on the Bursa Malaysia on clients' instructions.

In this case, the Singapore company does *not* have a PE in Malaysia purely by virtue of the share transactions on the Bursa Malaysia because the transactions were executed by an independent agent acting in the ordinary course of his business of stock broking.

Significance of having a PE: business profits attributable to a PE
If there is no PE, the enterprise from one country (Country A) will not be subject to tax in the other country (Country B). On the other hand, once a PE is established in Country B, the enterprise from Country A becomes taxable in the Country B, but only on so much of income as is attributable to the PE in Country B.

This is stated in paragraph 1 of Article 7 on business profits, dissected as follows:

> 'The profits of an enterprise of a contracting state (Country A) shall be taxable only in that state (Country A) unless the enterprise carries on business in the other contracting state (Country B) through a PE situated therein (Country B). If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state (Country B) but only so much of them as is attributable to that PE.'

The illustration below serves to explain what is meant by the above paragraph.

Illustration 8
A German company secured a contract to supply and install 500 wind turbines off the east coast of Peninsular Malaysia. The installation is expected to take up to 24 months. The contract comprises the supply of the 500 wind turbines

(constructed and fabricated in Germany) at a cost of RM500m and installation cost of RM200m.

The German company, in constructing and fabricating the wind turbines in Germany and sold to Malaysia, is said to be carrying its business activity of constructing and fabricating the wind turbines in Germany. When it sells the wind turbines to Malaysia, it is said to be doing business *with* Malaysia. No part of that income is attributable to its activities in Malaysia.

When installing the wind turbines for 24 months in Malaysia, the German company clearly has a fixed base through which it carries out its business activity of installing the wind turbines. Therefore, the income pertaining to the installation project of RM200m will in all likelihood be attributable to the PE in Malaysia as the activity is wholly carried out in Malaysia.

The German company will therefore be subject to tax in Malaysia in respect of the income it derives from the installation project in Malaysia for the duration of the project.

If the income thus subject to tax in Malaysia is also subject to tax in Germany – as is likely the case – then Germany, as the country of residence, will provide bilateral tax relief to alleviate the double taxation thus arisen.

Conclusion
It is important to have a working knowledge of double tax agreements when dealing with cross-border transactions. When the need arises to seek guidance from an agreement, first determine which DTA is applicable and then examine the relevant clauses of that particular DTA. When in doubt as to what a phrase or term means, it is always helpful to refer to the very informative commentaries on the OECD model convention.

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