

5. Dividends (Article 10 OECD-MC)

With regards to income from capital, the OECD Model distinguishes dividends (Article 10 OECD-MC) from interest (Article 11 OECD-MC). In stark contrast to the other distributive rules, both provisions provide for shared taxing rights between the source state and the residence state through the allocation of a limited primary taxing right to the source state. Such limitation is imposed given the expectation that the residence state will “top up” the level of taxation on dividends and interest.⁽¹⁾

5.1. Wording of the OECD Model Convention

1. **Dividends** paid by a company which is a resident of a Contracting State (*source state*) to a resident of the other Contracting State (*residence state*) **may be taxed** in that other State (*residence state*).

2. However, such dividends **may also be taxed** in the Contracting State (*source state*) of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (*residence state*), the **tax** so charged **shall not exceed**:

- a) **5 per cent** of the gross amount of the dividends if the *beneficial owner is a company* (other than a partnership) *which holds directly at least 25 per cent of the capital of the company* paying the dividends;
- b) **15 per cent** of the gross amount of the dividends *in all other cases*.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph **shall not affect** the *taxation of the company in respect of the profits out of which the dividends are paid*.

3. The term “**dividends**” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, *not* being debt-claims, participating in profits, **as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State** of which the company making the distribution is a resident (*source state*).

4. The provisions of paragraphs 1 and 2 **shall not apply** if the beneficial owner of the dividends, being a resident of a Contracting State (*residence state*), carries on business in the other Contracting State (*source state*) of which the company paying the dividends is a resident through a **permanent establishment** situated therein (*source state of the dividends/host state of the PE*) and the holding in respect of which the dividends are paid is *effectively connected with such permanent establishment*. In such case the provisions of **Article 7 shall apply**.

1 - In this respect, both Articles 23 A and 23 B OECD-MC provide for the application of the credit method.

5. Where a company which is a resident of a Contracting State (*residence state*) derives profits or income from the other Contracting State (*source state*), that other State (*source state*) may not impose any tax on the dividends paid by the company, **except insofar** as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

5.2. Allocation of taxing rights and avoidance of double taxation (Article 10 (1), (2) OECD-MC)

Article 10 OECD-MC deals with the taxation of dividends paid by a company which is a resident of a Contracting State to a recipient that is resident in the other Contracting State. While Article 10 (1) OECD-MC confirms the taxing right of the recipient's residence state, Article 10 (2) OECD-MC provides for a limited taxing right of the source state as follows:

- (i) the residence state of the company may levy withholding tax at a maximum of 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25%⁽¹⁾ of the capital of the company paying the dividends (Article 10 (2) a) OECD-MC).
- (ii) in all other cases, the source state may tax the gross amount of the dividends up to 15% (Article 10 (2) b) OECD-MC).⁽²⁾

Notably, the privilege of the reduced withholding tax rate under Article 10 (2) a) OECD-MC requires that the parent company be the beneficial owner of the dividends.⁽³⁾ This condition aims at avoiding an abusive application of the Convention via the interposition of agents, nominees or conduit companies (i.e. so-called "treaty shopping").⁽⁴⁾

As mentioned above, Article 10 OECD-MC provides for a primary taxing right of the source state that is limited according to paragraph 2 thereof, whereas the residence state retains a residual taxing right and has a correlative obligation to avoid double taxation.

1 - The 25% requirement is to be verified upon distribution and does not imply a minimum holding period (before the distribution).

2 - See Article 10 Paragraphs 9, 10 of the Commentary on the OECD Model Convention; see VOGEL, LEHNER (Double tax treaties 2008), Article 10, No. 36 - 40.

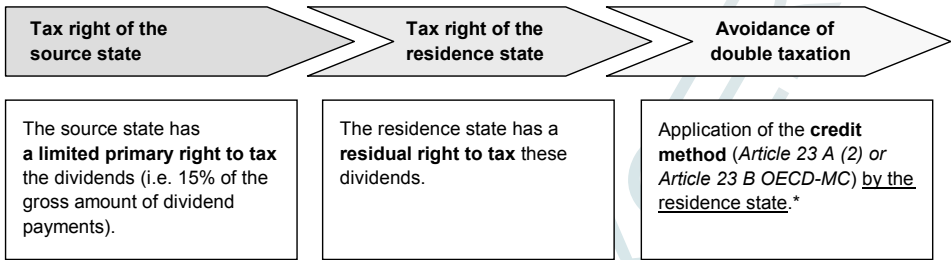
3 - The requirement that the recipient of the dividends be the "beneficial owner" thereof was added in the 1977 version of the OECD Model Convention in order to prevent treaty shopping; see VÉGH (OECD Model 2003), p. 249; the significant difficulties inherent in determining "beneficial ownership" are analyzed in OLIVER, LIBIN, VAN WEEGHEL, DU TOIT (Beneficial ownership 2000), p. 310 - 325 and WHEELER (Attribution of Income 2005), p. 477 - 488; see BAKER (Double tax Conventions 1994), p. 229; see VOGEL, LEHNER (Double tax treaties 2008), Before Articles 10 - 12, No. 11 - 20; see Chapter V, Section 2.3.3.

4 - See Article 10 Paragraph 12 of the Commentary on the OECD Model Convention; if dividends are received by a resident of a Contracting State in the capacity of agent or nominee, no relief or exemption should be granted by the source state merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. In these cases, the immediate recipient is not subject to potential double taxation with respect to this income since he is not treated as the owner of the income in his residence state. The same applies if the immediate recipient is a conduit company or other person, see VÉGH (OECD Model 2003), p. 249; see OLIVER, LIBIN, VAN WEEGHEL, DU TOIT (Beneficial ownership 2000), p. 310; see KANTER, REIJNIERSE, VOLLEBREGT (Beneficial ownership 2010), p. 192; see DU TOIT (Evolution of the term "beneficial ownership" 2010), p. 500; see WHEELER (Conflicts in the attribution of income to a person 1993), p. 36; see BAKER (Double tax Conventions 1994), p. 91; see BORREGO (Limitation on benefits clauses 2006), p. 81; see JEZZI (Beneficial ownership 2010), p. 253; see WASSERMAYER (Mißbräuchliche Inanspruchnahme von Doppelbesteuerungsabkommen 2003), p. 506; see VOGEL, LEHNER (Double tax treaties 2008), Introduction to Articles 10 - 12, No. 11, 12.

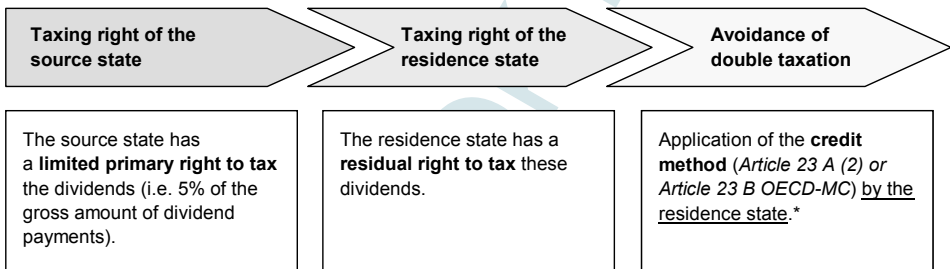
Here, the OECD Model provides for the credit method for the elimination of double taxation.

Taxation of dividends (Article 10 OECD-MC)

Scenario 1) Application of Article 10 (2) b) OECD-MC (15% withholding tax)



Scenario 2) Application of Article (2) a) OECD-MC (5% withholding tax)



* With regard to dividends both Article 23 A and 23 B OECD-MC provide for the credit method for the elimination of double taxation.

5.3. Definition of the term “dividends” (Article 10 (3) OECD-MC)

A definition of the term “dividends” is provided in Article 10 (3) OECD-MC. Nevertheless, in view of the great differences between various domestic laws, it is not possible to define the term conclusively. Therefore, dividends are defined broadly and flexible through several examples, including income from shares and “jouissance” rights. Moreover, reference is made to the domestic law of the source state in order to avoid qualification conflicts between the Contracting States.⁽¹⁾

1 - In other words, the reference to the domestic law of the source state should ensure a consistent application of the Convention; see Article 10 Paragraph 24 of the Commentary on the OECD Model Convention; see DJANANI, BRÄHLER (International taxation 2006), p. 149; see GIULIANI (Article 10 (3) of the OECD Model 2002), p. 13; see VOGEL, LEHNER (Double tax treaties 2008), Article 10, No. 184, 185.

In general, “dividends” cover distributions by companies within the meaning of Article 3 (1) b) OECD-MC to their shareholders and payments under securities issued by the companies that carry a right to participate in the companies’ profit insofar as they are not debt claims. Nevertheless, where interest is recast into dividend payments under application of the domestic thin capitalization rules, the interest payments may as well fall within the ambit of this category.⁽¹⁾

The characteristics of “interest” and “dividends” are summarized in the following overview:

Characteristics of dividends and interest	
Interest within the meaning of Article 11 (3) OECD-MC	Dividends within the meaning of Article 10 (3) OECD-MC
- Remuneration for the <i>allocation of money</i> (until repayment/redemption)	- Remuneration for the <i>contribution of capital</i> with business risks
- Paid on a <i>contractual basis</i>	- Paid in respect of the <i>shareholding relationship</i>
- Income deriving from <i>receivables</i>	- Income deriving from <i>participations</i>
- Payments for <i>debt</i> financing	- Payments for <i>equity</i> financing

On the contrary, distributions of profits by a partnership do not qualify as dividends within the meaning of Article 10 (3) OECD-MC, *unless* the partnership is liable to tax⁽²⁾ in the same way as a company in the state where its place of effective management is situated.⁽³⁾

5.4. Dividends realized through a PE (Article 10 (4) OECD-MC)

Article 7 (4) OECD-MC determines that Article 10 OECD-MC takes precedence over the former, where profits of an enterprise resident in a Contracting State include dividends deriving from a company that is resident in the other Contracting State. Thus, in accordance with Article 10 (2) OECD-MC, the source state has only a limited right to tax.

As an exception to this rule, Article 10 (4) OECD-MC determines that Article 7 OECD-MC applies where the participation is held as business property of a PE that the enterprise (of the other Contracting State) has in the residence state of the paying company.⁽⁴⁾ As a consequence, the source state’s taxing right is not subject to the limitations set out in Article 10 (2) OECD-MC; rather, the source state of the dividends (at the same time

1 - See Article 10 Paragraph 24 of the Commentary on the OECD Model Convention; see VOGEL, LEHNER (Double tax treaties 2008), Article 10, No. 203; see AIGNER (Die verdeckte Gewinnausschüttung im DBA-Recht 2003), p. 155; see TENORE (Taxation of dividends 2010), p. 222.

2 - Article 4 (1) OECD-MC.

3 - See Article 10 Paragraph 27 of the Commentary on the OECD Model Convention; see VOGEL, LEHNER (Double tax treaties 2008), Article 10, No. 190.

4 - The application of Article 10 (4) OECD-MC is conditional to the shareholding in respect of which dividends are paid to be “effectively connected” with a PE. This requires more than merely recording the shareholding in the books of the PE for accounting purposes. The standard of being “effectively connected” will only be met if the “economic” ownership of the shareholding is allocated to that PE under the principles developed in the report entitled Attribution of Profits to Permanent Establishments (adopted by the Committee on Fiscal Affairs on 22 July 2010); see Article 10 Paragraphs 32, 32.1 of the Commentary on the OECD Model Convention; similar provisions are included in Article 11 (4) OECD-MC, Article 12 (3) OECD-MC, Article 13 (2) OECD-MC, Article 21 (2) OECD-MC and Article 22 (2) OECD-MC.

the host state of the PE) has an unlimited primary taxing right to tax such dividends as business profits attributable to the PE situated therein.⁽¹⁾

Example: Participations held as business property of a PE in the source state

A company resident in State B (“B-Co”) is held by a company resident in State A (“A-Co”) through its PE situated in State B (“B-PE”). B-Co distributes dividends amounting to EUR 800,000 to its shareholder. In this case, the income is classified as business profits that are attributable to B-PE and State B has an unlimited primary right to tax the dividend income (Article 7 (1) s. 2 State A/ State B tax treaty).⁽²⁾

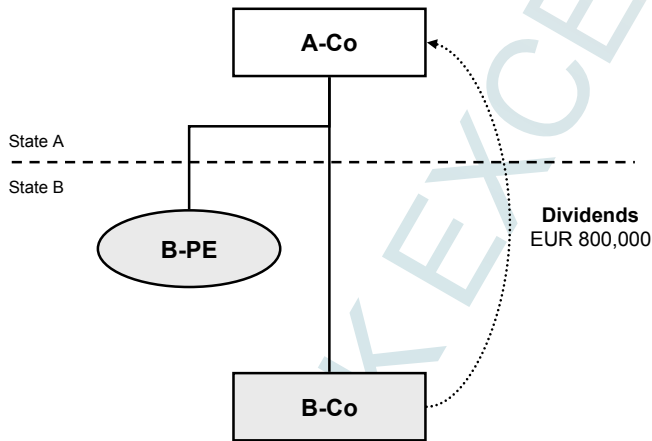
```
graph TD
    ACo[A-Co] --- BPE([B-PE])
    BPE --- BCo[B-Co]
    ACo -.->|Dividends EUR 800,000| BPE
```

It should, however, be noted that a PE of an enterprise that is resident in a Contracting State will not automatically attract all income deriving from sources in the other Contracting State; a concept commonly referred to as the “force of attraction”. Rather, the application of Article 10 (4) OECD-MC requires that the participation be “effectively connected” to the business property of the PE.⁽³⁾

1 - Article 7 (1), (2) OECD-MC.
2 - Article 10 (4) State A/State B tax treaty.
3 - See Article 10 Paragraphs 32 and 32.1 of the Commentary on the OECD Model Convention; similar provisions are included in Article 11 (4) OECD-MC, Article 12 (3) OECD-MC and Article 21 (2) OECD-MC.

Example: Inapplicability of “force of attraction” to PEs

On the basis of the previous example, it is assumed that A-Co directly holds the participation in B-Co. Here, the participation is not economically linked to the PE situated in State B (“B-PE”; i.e. the shareholding is not “effectively connected” with the PE). Consequently, the dividends are not classified as business profits (Article 10 (4) State A/State B tax treaty is not applicable). Instead, the income is subject to the provisions set out in Article 10 State A/State B tax treaty and the source state’s taxing right limited by Article 10 (2) State A/State B tax treaty.



In light of the bilateral nature of Article 10 OECD-MC, Article 10 (4) OECD-MC is not applicable where an enterprise of a Contracting State holds participations in the following companies through a PE in the other Contracting State (host state):

- (i) companies that are resident in the residence state of the enterprise; and
- (ii) companies that are resident in a third state.

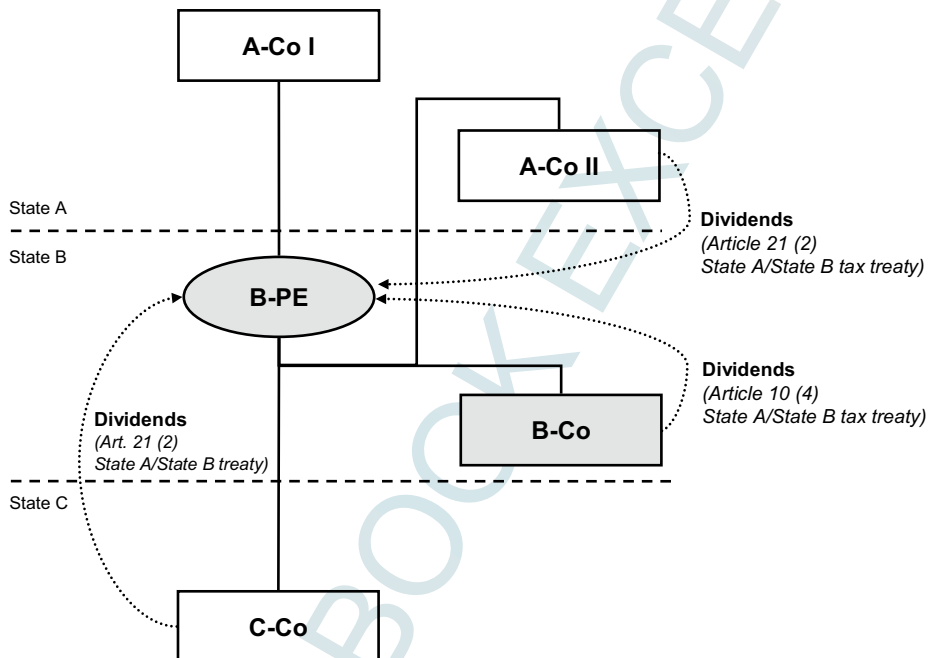
These cases are covered by Article 21 (2) OECD-MC that provides for the application of Article 7 OECD-MC. Accordingly, the host state of the PE also has an unlimited primary taxing right regarding dividends deriving from companies mentioned in (i) and (ii) above.⁽¹⁾

1 - See Chapter V, Section 16.3.

Example: The scopes of Article 10 (4) OECD-MC and Article 21 (2) OECD-MC

A company resident in State A ("A-Co I") holds three participations via a PE situated in State B ("B-PE"):

- a participation in a company resident in State B ("B-Co");
- a participation in a company resident in State A ("A-Co II"); and
- a participation in a company resident in a third state; i.e. State C ("C-Co").



Since Article 10 State A/State B tax treaty only covers dividends paid by a company resident in one Contracting State to a resident of the other Contracting State, Article 10 (4) State A/State B tax treaty may only apply with regard to dividends deriving from B-Co. In contrast, dividends received from A-Co II and C-Co fall within the ambit of Article 21 (2) State A/State B tax treaty providing for the application of Article 7 State A/State B tax treaty. It follows that all dividends are classified as business profits attributable to B-PE. Here, State B has an unlimited primary taxing right.

5.5. The prohibition of extra-territorial dividend taxation (Article 10 (5) OECD-MC)

Article 10 (5) OECD-MC provides for a prohibition of extra territorial taxation of dividends paid by a non-resident company and relates to the so-called secondary tax on dividends (or "branch profits taxes"). This is a tax levied by certain states⁽¹⁾ on profits realized by a

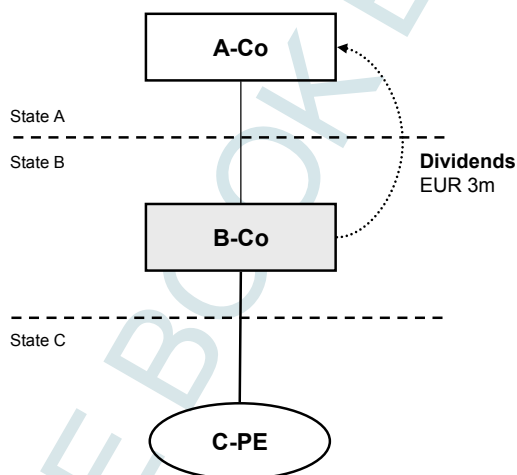
1 - For example the United States of America.

PE in addition to corporate income tax.⁽¹⁾ In contrast to distributions by companies that are classified as dividends, the allocation of profits by a PE to the head office is, in principle, not subject to dividend withholding taxes. In this respect, branch profits taxes aim at the same treatment of PEs and subsidiaries.

Whilst Article 10 (1), (2) OECD-MC is not applicable in these circumstances, Article 10 (5) OECD-MC rules out the taxation of dividends distributed by a non-resident company to a non-resident shareholder solely because the corporate profits from which the distributions are made originated in their territory.⁽²⁾

Example: Extra-territorial taxation

A company resident in State A ("A-Co") holds a participation in a company resident in State B ("B-Co"). B-Co realizes profits amounting to EUR 3,000,000 through a PE situated in State C ("C-PE") that are distributed to A-Co. Despite the profits – from which the distributions are made – originating from the territory of State C, the dividends distributed by B-Co may not be taxed by State C (Article 10 (5) State B/State C tax treaty).



It should, however, be noted that the prohibition of Article 10 (5) OECD-MC does not restrict a Contracting State to tax dividends paid to (i) a resident shareholder or (ii) a PE situated in its territory. Here, taxation is based on the receipt of dividend income and *not* on the payment of dividends by a company in another state.⁽³⁾

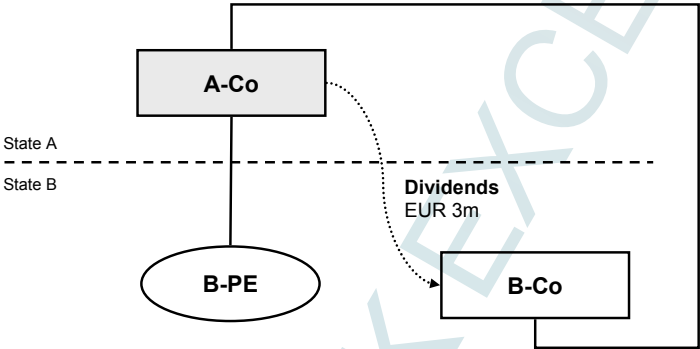
1 - See Article 10 Paragraph 33 of the Commentary on the OECD Model Convention; see VOGEL, LEHNER (Double tax treaties 2008), Article 10, No. 245 – 250; see BAKER (Double tax Conventions 1994), p. 233.

2 - See Article 10 Paragraph 34 of the Commentary on the OECD Model Convention; see MADEIRA (Article 10 (5) of the OECD Model 2007), p. 473.

3 - While in case (i), the taxing right of the host state of the PE may be derived from Article 10 (1) OECD-MC (i.e. the host state of the PE is at the same time the residence state of the recipient of the dividends), in case (ii), an unlimited primary taxing right of the host state of the PE may be based on Article 7 (1) OECD-MC (with regard to the dividends received by the recipient PE); see MADEIRA (Article 10 (5) of the OECD Model 2007), p. 474.

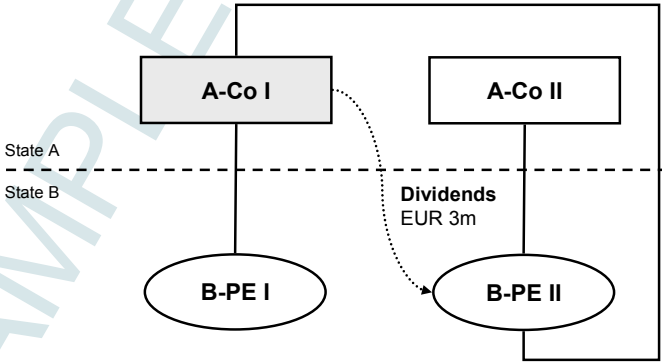
Example: Article 10 (5) OECD-MC – Exception (i)

A company resident in State B (“B-Co”) holds a participation in a company resident in State A (“A-Co”). A-Co realizes profits amounting to EUR 3,000,000 through a PE in State B (“B-PE”) that are distributed to B-Co. Here, Article 10 (5) OECD-MC does not apply. Rather, according to Article 10 (1), (2) State A/State B tax treaty, State A has a limited primary right to tax the dividends and State B retains a residual taxing right and has a correlative obligation to avoid double taxation.



Example: Article 10 (5) OECD-MC – Exception (ii)

A company resident in State A (“A-Co II”) holds through its PE situated in State B (“B-PE II”) a participation in a company resident in State A (“A-Co I”).⁽¹⁾ A-Co I realizes profits amounting to EUR 3,000,000 through a PE situated in State B (“B-PE I”) that are distributed to B-PE II. Here, State B has in accordance with Article 10 (4) State A/State B tax treaty (that takes precedence over Article 10 (1), (2) State A/State B tax treaty) an unlimited primary right to tax the profits attributable to B-PE II.



1 - It is assumed that the participation in A-Co I is effectively connected with that PE.

Finally, Article 10 (5) OECD-MC provides that non-resident companies may not be subjected to special taxes on undistributed profits.⁽¹⁾ This provision may appear to contravene “controlled foreign companies” legislation⁽²⁾ (i.e. so-called “CFC rules”) as implemented by several states. Nevertheless, since Article 10 (5) OECD-MC is limited to the taxation at source, it does not interfere with CFC rules that apply in the residence state of the shareholder.⁽³⁾

1 - See Article 10 Paragraph 36 of the Commentary on the OECD Model Convention.

2 - Whilst foreign-source income is usually taxed after it is accrued or received as income in the residence state of the recipient, under application of CFC rules, the domestic tax law effectively extends the residence tax rules to the income of the subsidiary. The purpose of these rules is to avoid tax deferrals realized at the level of an intermediary entity located in tax-free or low-tax jurisdictions until repatriation (i.e. so-called “base companies”). Therefore, tax is due on the foreign profits of the company notwithstanding if the profits are distributed or not. Indeed, where CFC rules apply a deemed dividend distribution is considered in the residence state of the shareholder.

3 - See Article 10 Paragraph 37 of the Commentary on the OECD Model Convention.