# Part I: Mobility and International Individual Taxation: Emerging Policy and Technical Issues Under National Tax Law and Treaties (Tax and Non-Tax)

# Chapter 7: Special Tax Regimes to Attract Individuals and Their Interaction with Treaty Law: Entitlement Issues

Hugo López López[*]

https://doi.org/10.59403/2j0zh11

## 7.1. Introduction

Mobility of individuals is increasing exponentially in recent times, and this is mainly caused by economic and developing imbalances between countries.[1] In fact, as long as these imbalances persist (or even increase), the movement of people will not cease, but rather the contrary will occur. Moreover, it is clear that technological advances are leading to what might be called a kind of "new nomadic way of life".

In this context, some countries try, on the one hand, to avoid the "brain drain" (i.e. income and investment drain), and on the other hand, to compete to attract "brain gain" (i.e. income and investment gain). Some of the measures used for this purpose are of a tax nature. Among the tax measures adopted in this respect, a distinction can be drawn between (i) defensive fiscal measures, aimed at preventing the flight of talent and income and investment by taxing individuals who move abroad (such as exit taxes, extension-based residence, the Bhagwati tax, etc.); and (ii) offensive tax measures, aimed at attracting and retaining highly skilled workers and income and investment.[2]

In this chapter, the author focuses on the second group of tax measures. In order to do so, the different types of offensive measures adopted by states will be briefly outlined (section 7.2.), separately analysing those aimed at retaining certain types of individuals (section 7.2.1.) and those aimed at attracting certain types of individuals (section 7.2.2.), while paying special attention to how both types of measure interact with tax treaties and, more specifically, entitlement issues and (double) non-taxation situations. The chapter ends with the conclusions (section 7.3.).

## 7.2. Offensive tax measures (tax incentives) and their interaction with tax treaties

As mentioned previously, in addition to defensive measures, states can adopt offensive measures or tax incentives to address the issue of international mobility and the "brain drain" and "brain gain" phenomena. Such measures can, in turn, be classified into two broad groups, namely (i) tax incentives aimed at retaining individuals; and (ii) tax incentives aimed at attracting individuals. The following sections of this chapter will analyse both types of tax regime and their interaction with tax treaties.

### 7.2.1. Tax incentives to retain individuals and their interaction with tax treaties

States can adopt tax incentives with the aim of retaining certain types of individuals within their jurisdiction and discourage them from moving abroad. Some countries have, in fact, implemented tax measures along these lines, such as income exemption rules or tax deductions.

At first glance, the interaction of these tax measures with tax treaties does not seem very problematic. Hence, when a state grants a tax exemption or any other tax incentive that benefits its residents in an attempt to limit or prevent undesired migration processes, there is no rule under the OECD Model Tax Convention (OECD Model) that prevents this insofar as the state of residence is entitled to do that.[3] Indeed, it is well known that tax treaties do not create tax obligations and, therefore, they do not oblige states to tax any type of income, and in particular – as far as we are concerned – business profits, independent personal services or

---

* Associate Professor of Tax Law, Universidad Pública de Navarra, Institute of Advanced Research in Business (INARBE).

1. Y. Brauner, *High-Skilled Migration: A Tax Perspective*, in *Taxation and Migration* (R. Avi Yonah & J. Slemrod eds., Wolters Kluwer 2015).
2. As showed by the EU Tax Observatory, during the course of the past three decades, EU countries have sought to reconcile the need to increase their tax attractiveness – in order to raise extra revenues and attract investments – with the need to avoid eroding their domestic tax base, so as not to jeopardize their resources. One solution to this difficult equation has been to cherry-pick foreign high-income taxpayers by implementing specific preferential schemes that only target new incoming residents. These schemes allow for the tax scale that is applied to the domestic population to be kept intact while gaining additional revenues by applying a reduced rate to foreigners. Although they were originally focused on income earned in the new tax residence country, these schemes have since been extended to foreign-source or worldwide income. In fact, in 1994, only five such scheme were in existence in the context of the European Union (UK and Irish remittance-based schemes, as well as Dutch, Belgian and Danish regimes), and in 2020 there were 28. *See* E. Flamant, S. Godar & G. Richard, *New Forms of Tax Competition in the European Union: an Empirical Investigation* p. 10 et seq. (Nov. 2021).
3. Setting aside residence issues, which will be analysed later.


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

employment income. Furthermore, article 23 of the OECD Model drafts different methods to avoid double taxation in the state of residence.

In fact, if the taxpayer maintains their residence in the state that grants the tax incentive and does not obtain income from another state, their tax situation will remain purely domestic and the tax treaty will not play any role.

The main issue that could arise regarding the limits contained in a tax treaty in relation to domestic tax regimes to retain individuals refers to the potential incompatibility of such a tax regime with the non-discrimination clause provided in article 24 of the OECD Model and, more specifically, the delimitation of the individuals benefiting from the special tax regime in light of this provision. In particular, as Souza de Man[4] notes: "[T]he fact that the state would not be restricted in its right to tax the resident individual does not mean that there would be no risk that the tax treaties signed by the states could lead to questions on the tax treatment granted to this individual. However, in that case the focus would not be on the distributive rules, but rather on the non/discrimination rule contained in Article 24(1)." According to article 24(1):

> Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation, or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provision of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

Thus, nationals of other states with which the state that grants the tax benefit has signed a tax treaty have to receive the same tax treatment as residents of the former state. That is, in order to comply with the treaty obligations, the tax benefit has to be extended to all nationals of the states with which the particular state has signed tax treaties. Some scholars[5] point out that fulfilling that obligation would lead to a great loss of tax revenue (i.e. the measure might be counterproductive). Setting aside financial policy issues – which must be balanced on a case-by-case basis for each state that intends to implement such a tax measure taking into account many other aspects – from a purely legal perspective, the potential problem of discrimination would be successfully overcome by focusing the tax benefit on residents (rather than the nationals) that the state really aims to retain.

Therefore, in the author's view, there is no issue regarding the compatibility of domestic tax benefits with tax treaties, provided that the state that grants the tax benefit extends it to the nationals of all states with which it has signed tax treaties.

## 7.2.2. Tax regimes to attract individuals

In addition to regimes for retaining certain taxpayers, states may adopt certain tax measures to attract such individuals from elsewhere. These measures are becoming increasingly widespread and are attracting a great deal of academic interest. The rationale for these tax regimes lies in the competition between countries to attract expatriate talent (highly skilled workers) and high net-worth-individuals (HNWIs). In fact, it can be viewed as a form of tax competition in many respects, analogous to tax concessions for foreign investment. For this reason, it has – as with many other topics – defenders and detractors.

In the majority of cases, special tax regimes that provide very significant tax benefits have been strongly criticized by some scholars as being detrimental to developing countries.[6] Furthermore, doubts arise as to the compatibility of such special tax regimes with fundamental principles on which modern tax systems are based, such as the principles of equality and ability to pay.[7] However, in this chapter, the author intends to exclusively analyse the compatibility of these special tax regimes with tax treaties, as the other issues could undoubtedly warrant a specific and independent contribution due to their importance.

In this regard, it shall be noted that it is not possible to offer a unique or immediate answer on the issue of the compatibility of tax regimes aimed at attracting taxpayers from other territories with tax treaties. In fact, as we will have the opportunity to demonstrate in this section, the answer will depend, among others, on how the specific tax measure under analysis is configured. For this reason, the author will first outline the most relevant characteristics of the different types of measure adopted by states to attract individuals. An exhaustive analysis of each and every one of the measures adopted by states is not intended here, nor to analyse in detail some of more common regimes[8] – but rather the purpose is simply to set out the general characteristics that these special regimes may share. From there, we will be able to identify and analyse the potential problems which, depending on the characteristics adopted by the particular regime, they may pose from the perspective of their compatibility with the tax treaty.

---

4. F. Souza de Man, *Tax Measures to Combat Brain Drain: (in)compatibility issues with Double Tax Conventions and a Potential way forward*, Annals of the Belgrade Law Review 4 (2019).
5. Id.
6. Id., at p. 272 and literature quoted therein.
7. A. Báez Moreno & H. López López, *Brain Drain Tax vs. Brain Gain Benefits: General Thoughts from a Spanish Perspective*, Annals of the Belgrade Law Review 4 (2019).
8. *See* ch. 6 of this book.


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

In general, it should be noted that the application of these tax incentives requires a series of prerequisites, such as (i) not having been resident for a certain period of time in the country granting the tax benefit; (ii) not coming from a place located less than a certain distance from the border of that state; (iii) prior investment in the state offering the special regime, etc.

The material content of the incentive, which is the most relevant aspect for the purposes of this chapter, also varies from one state to another and might even differ within the same country depending on the characteristics of each approved tax incentive that aims to attract HNWIs and highly skilled workers. In particular, tax benefits may consist of, inter alia, an exemption on a certain percentage of income; an exemption on all or some of the categories of foreign-source income; taxation on foreign income on a remittance basis; taxation at a proportional tax rate instead of a progressive rate; a flat amount of income tax; expenditure-based taxation; exclusion from liability under controlled foreign company legislation; and non-resident trust regimes, or some combination of these, etc. Broadly speaking, it can be held that in many (but not all) cases, such regimes are based on the assumption that the tax treatment of inbound expatriates is fully or partially similar to that of non-residents.

Finally, these tax incentives are usually granted for a certain period of time, and sometimes they are also subject to the approval of the relevant tax authorities.

Regarding the interaction of these tax regimes with tax treaties, although some scholars[9] argue that there is no conflict insofar as they merely determine that a state will give up the right to tax part of certain individuals' income on terms similar to those described previously in relation to tax incentives for retaining individuals, in the author's view, the answer is not quite so straightforward. As will be explained later, the answer depends on the domestic law of each state; the clauses included within the corresponding tax treaty; its particular interpretation; and the circumstances of each individual under the scope of the special attraction regime.

In this respect, it is crystal clear that the state of residence or home state – the one that grants the tax benefit – is not restricted by a tax treaty in its right to tax such an individual, because it is up to the state to determine in its domestic legislation whether and how the individual will effectively be taxed. But the major concern is precisely that, depending on the tax liability configured by the state, doubts can arise regarding how the tax treaty is applied to the individuals that benefit from such a special regime. More specifically, it might be questioned whether all special tax regimes to attract individuals fulfil the requirements contained in article 4(1) of the OECD Model in order to be considered a resident. Furthermore, even if the individuals benefiting from the special tax regime are considered to be resident according to article 4(1), the interaction of such special tax regimes with the allocation rules contained in the tax treaty can lead to "no taxation situations" (double non-taxation). These scenarios have also provoked an interesting discussion, mainly at the fiscal or tax policy level. The discussion in this chapter will focus purely on legal aspects.

In what follows, the author intends to analyse the above-mentioned issues separately.

### 7.2.2.1. Special tax regimes to attract individuals and tax treaty entitlement

It is well known that under the OECD Model, article 1 provides that "[t]his Convention shall apply to persons who are residents of one or both of the Contracting States".

Consequently, residence is seen as a requirement for access to a tax treaty. In this regard, tax treaties generally respect the practice of domestic law when it comes to the definition of "residence". Thus, article 4(1) of the OECD Model, when defining the term "resident of a Contracting State", basically refers to the domestic law definition for a resident, as follows:

> "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 as well as a recognised pension fund of that State. 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".[10]

---

9. Souza de Man, *supra* n. 4, at pp. 271-272. Along the same lines, focusing mainly on the special tax regimes in Italy, G. Beretta, *From Worldwide to Territorial Taxation: Is Italy Now an Attractive Destination for Migrating Individuals?*, 71 Bull. Intl. Taxn. 8, p. 441 (2017), Journal Articles & Opinion Pieces IBFD, considers that, generally, the answer to this question is positive. As a matter of fact, a taxpayer opting for the regime remains liable and subject to that country's income tax on overall income, including foreign income, even though income tax is levied only on domestic-source income, while foreign-source income is either exempt or taxed at concessionary rates, quoting R. Ismer & K. Riemer, *Article 4 OECD MC (Resident)*, in *Klaus Vogel on Double Tax Conventions – A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice* p. 34 (5th ed., E. Reimer & A. Rust eds., Wolters Kluwer 2015). *See also* G. Beretta, *Mobility of Individuals after BEPS: The Persistent Conflict between Jurisdictions*, 72 Bull. Intl. Taxn. 7 (2018), Journal Articles & Opinion Pieces IBFD.
10. *United Nations Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2017), Treaties & Models IBFD, contains a similar provision, save that it includes the criterion "place of incorporation" immediately before the words "place of management". In addition, it does not include the stipulation regarding a recognized pension fund. The *United States Model Income Tax Convention* (17 Feb. 2016), Treaties & Models IBFD [hereinafter *US Model* (2016)], deviates from the *OECD Model Tax Convention on Income and on Capital* (27 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model*], by including "citizenship" and "place of incorporation" among the list of criteria. Also, with regard to the above-quoted second sentence in art. 4(1) *OECD Model* (i.e. excluding from the definition those persons liable to tax in a particular state in respect of income only from sources in that state), the *US Model* provision is much broader in scope as it also excludes from the definition of "residence" any person whose tax is determined in that contracting state on a fixed-fee, "forfeit" or similar basis. Art. 4(2) *US Model* (2016) contains further provisions on the definition of "resident of a Contracting State". Included within the definition are pension


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

From the analysis of this provision, it can be inferred that the concept of "resident" is of the utmost relevance and plays a key role in the application of the convention. The reason for this is that only a person who is a resident of one or more contracting states is entitled to tax treaty benefits.

The above-mentioned provision defines what "resident of a Contracting State" means for tax treaty purposes, and it is divided into two different parts or sentences that should be analysed separately. This analysis will be carried out in the next section.

### 7.2.2.1.1. Article 4(1): General definition of "residence"

First of all, the definition of "residence" contained in article 4(1) departs from a reference to the domestic legislation of the contracting state (i.e. "under the laws of that State"). However, such a reference is generally understood as partial, limited or conditional, in the sense that a person will be deemed resident for the purposes of the convention insofar as they are a resident in accordance with the domestic law of the contracting state to the extend the criterion used by the domestic law is a substantive or material one that ultimately establishes a special link between the subject and the state of residence. Although this is the way in which article 4(1) has generally been interpreted, in the author's opinion, this is a questionable and a somewhat contradictory statement for several reasons.

Firstly, from the wording of the provision, it does not appear that there is a clear intention to limit the residence to substantive or material criteria, establishing a close link between the taxpayer and the state of residence. In fact, as some scholars have suggested, it is quite possible that the normative results of BEPS have accentuated the possibility of understanding article 4(1) of the OECD Model as an unconditional reference to the contracting states' domestic law with regard, in particular, to individuals.[11]

Secondly, the material or substantive requirement of some of the criteria explicitly mentioned in article 4(1) is, at the very least, debatable.[12] This is the case with the domicile criterion and the residence criterion itself, which is extraordinarily vague and redundant. In fact, stating that a person is a resident in a contracting state if they are resident in accordance with domestic law – as far as that person is liable to tax therein by reason of their residence – is a circular argument that does not provide much clarity and does not, in the author's opinion, allow the inference that a substantive or material nexus with the state of residence is required.[13]

Thirdly, such interpretation of article 4(1) is inconsistent with some tie-breaker rules provided for in paragraph 2 to deal with double tax residence scenarios. In this regard, it is clear that tie-breaker rules are not residence rules but criteria to provide solutions to double-residence situations. However, one of those criteria (e.g. the very first tie-breaker rule provided for in article 4(2) to determine the state of residence when an individual is a tax resident in both contracting states according to their domestic law) refers to the permanent home available to them. An available permanent home does not seem to be a substantive criterion to infer a special link between the individual and the state of residence. The same holds true in relation to other tie-breaker criteria, such as nationality. Again, as it should be emphasized, tie-breaker rules are not residence rules but, rather, they provide some guidance on determining with which of the two states involved the individual has a stronger (material) link or connection. However, this may be useful in determining the context in which paragraph 1 of article 4 has to be interpreted and, in particular, the scope of the references to domestic rules on tax residence. Therefore, a systematic interpretation of article 4(1) and (2) would lead to the conclusion that material or substantive elements are not an inherent requirement for the definition of "residence" contained in article 4(1).

Be that as it may, what is certain is that the opinion that there are two types of residence – one for internal or domestic purposes and the other for purely conventional purposes, which do not necessarily coincide – is commonplace among academic doctrine[14] and has also been supported by case law[15] and the domestic legislation of some states.[16] Thus, a particular individual may be considered resident for the purposes of a country's domestic law, but if the link with that country is not sufficiently strong (whatever "strong" means), they will not be considered a resident for treaty purposes and, therefore, will not be entitled to tax treaty benefits.

---

funds established within a contracting state. The definition also covers organizations that are established and maintained in a contracting state exclusively for religious, charitable, scientific, artistic, cultural or educational purposes. In the case of such pension funds and organizations, it is immaterial whether they are wholly or partly exempt from tax under the domestic law of the contracting state.

11. *See* in this respect, ch. 8 of this book.
12. *See* S. Kostic, *In Search of the Digital Nomad – Rethinking the Taxation of Employment Income under Tax Treaties*, 11 World Tax J. 2 (2019), Journal Articles & Opinion Pieces IBFD.
13. On the notion of domicile and residence, their historic development and current meaning, *see* M. Dirkis, M. *The Expression "Liable to Tax by Reason of His Domicile, Residence" Under Art. 4(1) of the OECD Model Convention*, in *Residence of Individuals under Tax Treaties and EC Law* (G. Maisto ed., IBFD 2010), Books IBFD.
14. Among others, *see* R. Ismer & K. Riemer, *Article 4*, in *Klaus Vogel on Double Taxation Conventions*, vol. I, p. 238 (Wolter Kluwer 2017).
15. *See* judgements of PT: Supreme Administrative Court, 25 Mar. 2009, Case n. 068/09, sec. 2; and PT: Supreme Administrative Court, 24 Feb. 2011, Case n. 0876/10, sec. 2.
16. Spain is a clear example, in particular, art. 120 of ES: *Reglamento del Impuesto sobre la Renta de las Personas Físicas* [hereinafter PIT regulations], which will be discussed later.



© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

The first part of article 4(1) of the OECD Model links tax residence in a contracting state, and therefore applying the convention's benefits, to the person being "liable to" tax in accordance with the domestic legislation of the residence. This link is based on substantive criteria.

When it comes to delimiting the scope of this provision, there is a fairly general consensus on the need to distinguish between the concepts of "tax liability" and "subject to tax". As some scholars point out,[17] as a matter of ordinary use of language, the two terms mean the same but, in the OECD Model, the two expressions are used consistently in a particular way. According to Avery Jones, "liable to tax" applies to *persons* and refers to whether a person is or is not taxable as a resident without considering separate sources of income.[18] Conversely, "subject to tax" refers to whether a particular *item of income* is taxable or not. In other words, "subject to tax" applies to a person ("a person … is subject to tax"), but the crux of the matter is whether the particular item of income is taxed. If "subject to tax" is used in a tax treaty article in relation to income, the taxpayer must satisfy two conditions: (i) that they are generally *liable to tax* on income; and (ii) that they are subject to tax on the particular income. That being said, in general, many countries have adopted the approach that being "liable to tax" is not dependent upon being actually subject to a real tax charge.[19]

In this regard, according to the first part of article 4(1) of the OECD Model, "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 as well as a recognised pension fund of that State" and refers only to "tax liability" and not to "subject to tax".

On this basis, it could be stated that the special regimes for attracting individuals being analysed comply with the requirements contained in the first sentence of article 4(1) of the OECD Model, insofar as they require that the individual benefiting from such tax regimes be resident in accordance with the general residence rules of that state – but only provided that these rules employ substantive criteria.

Conversely, where an inbound expatriate's residence is determined based on non-substantive criteria, this individual will not have access to the benefits of the tax treaty. To the extent that special regimes for individuals are usually based on general residence rules, this will not be a problem specific to the special tax regime but a general issue of residence rules. In any case, special tax regimes aimed at attracting individuals based on residence rules – whether specific rules to benefit from the special tax regime or general residence income tax rules – that adopt a weak link with the state of residence cannot benefit from the tax treaty.

The difficulty is to determine which links are "similar" in nature to domicile, residence and place of management and which are not. Some countries, well known for their special tax regimes to attract individuals, have provided for certain residence criteria which have proved problematic from the point of view of their compliance with the criterion provided for in the first part of article 4(1). That is the case of Portugal, which established the "residency by dependence" criterion, which is currently repealed. According to this criterion, an individual was considered resident in Portugal for tax purposes for the mere fact that another member of their family unit (e.g. spouse) was resident in this state due to substantive criteria (e.g. days of physical presence in Portugal). In this regard, the Highest Administrative Court of Portugal delivered some decisions on the tax treaty signed by Portugal and Germany.[20] In particular, it was ruled that the treaty was based on a substantive or meaningful link between the individual and the contracting state (Portugal) and that a mere "residence by dependence" criterion did not fulfil such substantive criteria for treaty purposes. According to the Court, the individual did not demonstrate any real and effective link between the majority of his economic activities and the Portuguese territory as required by article 4 of the Germany-Portugal tax treaty, which follows the OECD Model in this respect. Therefore, even if the individual was considered resident from a domestic perspective, he was not resident in Portugal for tax treaty purposes.

Italy is another country that is well known for its preferential tax regimes that are aimed at encouraging certain individuals to relocate their tax residence to Italy. Tax residence may be acquired by virtue of residence (habitual abode), domicile (centre of vital interest) or registration in the local municipality.[21] The latter does not seem to meet the substance or material requirement for an individual to be entitled to treaty benefits. Therefore, similar problems to those just mentioned regarding the Portuguese case will arise.

In any case, it should be stressed that the above-mentioned issue is not a problem specific to special regimes for individuals but a general challenge affecting any natural person who acquires residence by applying this type of non-substantive criteria, whether

17. Among others, J.F. Avery Jones, *Wiser v HMRC: why do we need "liable to tax" and "subject to tax" clauses?*, British Tax Review 1 (2014).
18. Setting aside, at this stage, the impact of the second sentence in art. 4(1) *OECD Model*.
19. *See*, for example, the judgements of SE: RR [Supreme Administrative Court], 23 Dec. 1987, Case RA 1987 ref. 162; SE: RR, 2 Oct. 1996, Case RA 1996 ref. 84, Case Law IBFD; and SE: RR, 5 Apr. 2004, Case RA 2004 ref. 29, Case Law IBFD. As to the Netherlands, the Hoge Raad has held (*see* NL: HR [Supreme Court], 2 Oct. 1996, Case 31.135, BNB 1996/358, Case Law IBFD) that it was irrelevant that the taxpayer was not actually subject to tax in the other state quoted by B. Obuoforibo, *Article 4: Resident – Global Tax Treaty Commentaries*, Global Topics IBFD (accessed 21 Sept. 2022).
20. PT: 2nd Section Supreme Administrative Court, ruling of 25 Mar. 2009, process number 068/09 and 24 Feb. 2011, process number 0876/10.
21. *See* ch. 6 of this book.


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

or not they benefit from the special tax regimes for individuals. Indeed, the special tax regimes for individuals do not provide for specific residence rules but are based on the general rules for personal income tax and, therefore, do not present any specific problem in this respect.

### 7.2.2.1.2. Article 4(1): Exclusion from the definition of "residence"

The definition of "residence" in the first sentence of article 4(1) only refers to individual tax liability. In other words, it makes no reference to the way the income obtained by the liable person is taxed and, in particular, whether or not the tax liability gives rise to an actual taxation of income. From this perspective, it could be considered that the provision only refers to a mere potential taxation. As a result, it seems that the way the individual's income is taxed, if any, has no impact on the determination of whether the individual is a resident or non-resident for the purposes of the tax treaty.

Nevertheless, according to the second sentence of article 4(1), residence for treaty purposes "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".

This last statement is of great interest in terms of our analysis, as some of the special tax regimes to attract individuals are based on the taxation of the income obtained in the state that grants the tax benefit (i.e. state of residence or host state). However, its scope and interpretation are far from being clear.[22]

Unlike the first sentence of article 4(1) which, as noted previously, defines "residence" based on the liable-to-tax criterion, the second sentence denies the consideration of residence for the purposes of the tax treaty based on the subject-to-tax criterion. Scholars[23] consider that the interpretation issue arising from the current OECD Model is to determine at which point along this grade or scale a person ceases to be "liable to tax" and is, therefore, not entitled to treaty protection. More specifically, regarding special tax regimes to attract individuals, it is accepted that treaty entitlement should not be disputed where the exemption in the state of residence is limited to a single item of income but is not structural to the regime itself. In this case, the state of residence could be said to maintain a "quasi-full tax liability".[24] However, in the author's opinion, it is not a question of the degree of tax liability as long as liability is not a scalable or gradable concept. It has to be highlighted that, from a purely theoretical or conceptual point of view, even a person who is not taxed at all can be considered liable to tax and, therefore, a taxpayer. Hence, an individual is liable to tax or not. It is a straightforward distinction. What can be subject to graduation is the taxation of the income obtained by the taxable individual.

A quick look at the second part of the provision suggests that, for an individual to be considered a tax resident for treaty purposes, it is necessary that some of their foreign income is subject to tax. At first sight, this interpretation denies the entitlement of tax treaty benefits to individuals subject to territorial tax systems. However, such an interpretation has been expressly rejected by the OECD since the 1992 Commentaries.[25] According to the OECD Commentaries, a person shall not be considered a "resident of a Contracting State" for the purposes of the convention if, although not domiciled in that state, they are considered to be a resident according to the domestic laws but are limited to taxation on income from sources in that state or on capital situated in that state. However, the OECD highlights that that phrase must be interpreted restrictively as, otherwise, it might exclude any resident from countries adopting a territorial principle in their taxation from the scope of the convention, a result which is clearly not intended. In the author's view, it is not possible to state which interpretation, departing from the wording of the second sentence in article 4(1), would achieve such a conclusion or outcome. Considering that the OECD Commentaries have no binding legal value, the author believes that it is more consistent with the wording of the above-quoted provision quoted that those tax treaties including the second sentence in article 4(1) exclude taxpayers subject to a territorial tax system from their scope of application. In this respect, it is significant that some states with territorial tax systems do not usually include this provision in their treaty network,[26] or they introduce a deviation from the Model to expressly include their residents in the tax treaty scope.[27]

---

22. *See* A. de Graaf & F. Pötgens, *Worrying Interpretation of 'Liable to Tax': OECD Clarification Would Be Welcome*, 39 Intertax 4 (2011).
23. Among others, J. Wheeler, *The Missing Keystone of Income Tax Treaties*, 3 World Tax J. 2 (2011), Journal Articles & Opinion Pieces IBFD. Also, on the interpretation of the tax treaty concluded by China and Australia (1988) under the light of special tax regimes for individuals provided by both states, N. Sharkey, *Tax Treaties and Temporary Residence for Individuals: Tax Abuse? – Focus on the Rules in Australia, China (People's Rep.) and Singapore in the Context of the Tax Treaties between These States and with India, Japan, Korea (Rep.) and the United Kingdom*, 69 Bull. Intl. Taxn. 2, p. 76 (2015), Journal Articles & Opinion Pieces IBFD.
24. *See* ch. 6 of this book. Along these lines, S. Mutis, *Australia/Portugal/Spain/Switzerland Can Special Attraction Regimes Lead to Treaty Residence?*, 72 Bull. Intl. Taxn. 9 (2018), Journal Articles & Opinion Pieces IBFD, in particular, when referring to the Spanish special tax regime for inbound expatriates (which will be discussed later) and the Australian regime, concluding that, insofar as these special tax regimes do not provide the most comprehensive liability to tax and treat inbound expatriates in the same way as non-residents regarding most of their foreign-source income, individuals benefiting from these favourable tax regimes are not considered resident for treaty purposes.
25. *See OECD Income and Capital Model Convention and Commentary* para. 8 (1 Sept. 1992), Treaties & Models IBFD.
26. That is the case, for instance, of Singapore in the tax treaty signed with the Republic of Finland, the Kingdom of Spain or the Republic of Mauritius. In the latter, there is a total remission of the concept of residence in the domestic legislation for the purpose of the treaty residence. Other examples include some of the tax treaties signed by the Republic of Bolivia with the French Republic, the federal Republic of Germany, the United Kingdom of Great Britain and Northern Ireland, as well as the tax treaty signed between the Republic of Costa Rica and Romania.
27. That is the case of the *Bol.-Swed. Income Tax Treaty* (1994), Treaties & Models IBFD. According to art. 4, second sentence: "The term 'resident of a Contracting State' does not include any person who is liable to tax in that State in respect only of income from sources in that State, however, this term does include any


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

To properly understand the context in which such a provision was included in the Model, the OECD Commentaries (1963) and the amendments drafted in this respect in the OECD Model (1977) shall be analysed. The Commentary on Article 4(1) of the OECD Model (1963) included an equivalent clause to the second sentence, which reads as follows: "[A]n individual, however, is not to be considered a 'resident of a Contracting State' in the sense of the Convention if, although not domiciled in that State, he is considered as a resident according to the national law and is only subject to a limited taxation on the income arising in that State."

As it was evident that such an interpretation of article 4(1) of the OECD Model (1966) was not derived from article 4, the 1977 draft included this new provision that has been maintained in subsequent versions to the present day. The introduction of the new statement was intended to deny entitlement to tax treaty benefits to certain individuals, in particular, to those whose state of residence granted them tax privilege by taxing only income from the source in the state of residence (particularly, diplomats). The OECD's Commentary on Article 4(1) (1997) stated that the very first part of article 4(1):

> also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service). In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory.[28]

According to Avery Jones,[29] like the OECD Commentaries (1963), these provisions were restricted to individuals, presumably because it was mainly needed to deal with diplomats. In fact, diplomats would otherwise not be taxable in their state of origin (because they were not resident there unless there were special provisions specifically taxing them) while, at the same time, they would be taxable only to a limited extent in the host state which, unless excluded as treaty residents, would have entitled them to use the host state's treaties (because of international law immunity). Given that the OECD Commentaries indicate that a particular class of people are foreign diplomatic and consular staff serving in their territory, it is also argued that the scope of the second sentence is very narrow and there are suggestions that it only applies if there is a total exemption of foreign income.[30]

Somehow, similar situations could arise regarding some special tax regimes designed to attract new residents by providing a privileged tax regime, whereby only the income from the new resident state is subject to tax. In these cases, in the author's opinion, the individuals would not be entitled to the treaty benefits if the affected tax treaty follows the OECD Model. In fact, the wording of the second sentence in article 4(1) may *prima facie* operate to exclude an expatriate person from the treaty's scope of application.[31]

However, this might be questionable if words are strictly interpreted regarding those special tax regimes for inbound expatriates benefiting from a tax exemption on the vast majority of their non-resident-source income, but remaining taxable on a notable amount of foreign-source income on the basis of their residence. This is the case for most – if not all – special tax regimes for individuals which do not exclude certain items of income from taxation (e.g. foreign-source employment income).[32] In the author's opinion, insofar as the wording of the second sentence in article 4(1) is clear when providing the exclusion "only subject to a limited taxation on the income arising in that State" and that these tax regimes do not exclude all foreign income from taxation, they do not fall under the exclusion of residence criteria.

---

person resident in Bolivia who is liable to tax under Bolivian laws." The *Costa Rica-Ger. Income and Capital Tax Treaty* (2014), Treaties & Models IBFD, includes in the Protocol the following assessment: "As long as the Republic of Costa Rica's tax system remains based on the territorial tax principle, the provision of sentence 2 of paragraph 1 of Article 4". However, more confusing seems to be the *Costa Rica-Spain Income and Capital Tax Treaty* (2004), Treaties & Models IBFD. Para. 2 of the Protocol reads as follow: "While one of the Contracting States maintains a territoriality criterion in its taxation system, where by application of the provision of Articles 6 to 21 of this Convention the taxing power rests exclusively with that State and pursuant to such territoriality criterion an item of income is deemed not to arise in that State, such income may be taxed in the other State as if the Convention had no entered into force." According to F. Vega, *El Convenio para evitar la doble imposición entre Costa Rica y España: Particularidades y aspectos controvertidos*, Revista Análisis Tributario 13, p. 27 (2015), from this clause the status of residents for the purposes of the convention can be implicitly derived. In the same vein, the vast majority of the tax treaties signed by Hong Kong, including those with the Republic of India, the Kingdom of Spain, the Republic of Serbia, the Kingdom of Belgium, when defining the term "resident of a Contracting Party" expressly mentions that the last sentence of art. 4(1) does not preclude a person from being treated as a resident in a contracting party by reason of a territorial source principle in the taxation system of that party; in the same vein as in the treaty signed with Belgium, see the one signed with the Republic of France in its Protocol 5; the Republic of Mauritius; Switzerland; the United Kingdom; the Socialist Republic of Vietnam; the State of Kuwait; Malaysia; New Zealand and the Republic of Korea.

28. Paradoxically, art. 27 *OECD Model* (related to diplomatic agents and consular officers) establishes: "Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements."
29. J.F. Avery Jones, *The Beneficial Ownership Concept Was Never Necessary in the Model*, in *Beneficial Ownership: Recent Trends* (M. Lang et al. eds., IBFD 2013), Books IBFD.
30. Dirkis, *supra* n. 13.
31. However, some case law of courts of first instance, such as France, has accepted the entitlement to treaty benefits of individuals benefiting from preferential tax regimes provided for certain countries, such as Israel, which limit taxation to income earned in the country of residence. *See* FR: CAA de Toulouse, the first section (chamber) of 13 Oct. 2022, case number 20TL22832.
32. Sharkey, *supra* n. 23, at p. 75.



© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

Notwithstanding the foregoing, there are countries that go even further and exclude those individuals who benefit from such special tax regimes from treaty benefits, even if such a special tax regime does not restrict taxation on pure source income from the state of residence but rather taxes some items worldwide. This is the case in Spain.

Broadly speaking, the Spanish special tax regime consists of an option for inbound expatriates fulfilling certain requirements to be taxed as non-residents. In particular, these individuals may choose between being taxed as ordinary residents at a progressive rate of up to approximately 45%[33] or, if deemed non-residents, at a proportional rate of 24% on Spanish-source income (excluding employment income, which is taxed worldwide). However, according to the Spanish domestic legislation,[34] such a special tax regime precludes the application of the Spanish tax treaty network to those residents opting for it. In this regard, domestic regulation enables a certificate of residence to be issued for beneficiaries of the special tax regime. According to the regulation, this certificate, however, is not proof of residence in Spain for tax treaty purposes. In the author's opinion, this regulation creates some fundamental restrictions for individuals that shall be strongly criticized.

Setting aside the regulation's potential lack of legality, from the author's perspective, another relevant issue relates to treaty override concerns. In fact, whether an individual is entitled to benefit from a particular tax treaty is something that must be determined by interpreting the particular tax treaty at stake and cannot be predetermined by the domestic legislation, even less so by a regulation. The latter might only happen if the content of the special tax regime results in the exclusion of the tax treaty insofar as it prevents the residence conditions provided for in the convention from being deemed fulfilled,[35] and the domestic provision only clarifies the interpretation of the tax treaty and, more specifically, the second statement of article 4(1) under discussion. This, in the case of the Spanish tax regime, is far from being self-evident. In fact, some of the tax treaties signed by Spain (such as the Germany-Spain Income and Capital Tax Treaty (2011)),[36] contain a special provision that explicitly excludes those individuals that benefit from the special tax regime from the scope of application of the tax treaty. Such an explicit exclusion[37] demonstrates the lack of clarity in this regard. Moreover, a tax treaty denying entitlement explicitly to those individuals that opt for the special tax regime is a strong argument to demonstrate, at least regarding this particular treaty, that without such a provision inbound expatriates would benefit from the tax treaty.

The treaty override is evident with respect to those conventions signed by Spain that do not incorporate the second sentence of article 4(1) (i.e. that define "resident of a Contracting State" by exclusive reference to the criterion of liability to taxation)[38] and do not explicitly exclude individuals who have opted for the special taxation regime from the convention. In fact, as already mentioned, the OECD's Commentary on Article 4(1)[39] notes that the first part of the paragraph covers cases where a person is deemed to be a resident in that state and is liable to tax therein, including diplomats or persons in government service. In those tax treaties signed by Spain that do not include the second phrase in article 4(1) of the OECD Model, the residence issue is defined in the vast majority of cases by referring to the domestic legislation. According to the Spanish domestic legislation, for an individual to benefit from the special tax regime, it is mandatory that they are resident in Spain according to the general residence rules for individuals.[40] Therefore, a regulation such as the one contained in article 120 of the Personal Income Tax Regulation, according to which the application of the tax treaty network is precluded to those residents opting for the special tax regime, is clearly in breach of the principle of legality and constitutes a treaty override.

Doubts could also arise regarding individuals who benefit from special tax regimes that operate based on a remittance system (such as the well-known UK system or Japanese one). According to this tax regime, an individual who is a resident in that state but is neither domiciled nor ordinarily resident there, may elect to be taxed on income arising outside the state or on capital gains on assets held outside of the state on a remittance basis. As these persons are residents under the country's domestic law, in principle, they satisfy the "domicile, residence" criteria under article 4(1). The question that arises is whether this individual falls within the first sentence in article 4(1), "liable to tax", as they are not subject to comprehensive taxation to the extent that the foreign income is only taxed on a remittance basis. As discussed in chapter 6 of this book, the applicability of the tax treaty to individuals who are resident but non-domiciled in the United Kingdom (the "resident non-dom") has been highly debated in case

33. Depending on the particular autonomous community in which the individual resides.
34. Art. 120 PIT regulations.
35. In this case, the domestic provision would be superficial, as far as the same conclusion would be reached from the interpretation of the tax treaty.
36. According to para. 2 of the Protocol to the *Ger.-Spain Income and Capital Tax Treaty* (2011), Treaties & Models IBFD, on art. 4: "Articles 4, 6 to 21 of this Agreement shall not apply to Spanish taxpayers who have opted for being taxed according to non resident tax Law, as is provided by article 93 of the Spanish individual Income Tax (Ley 35/2006, de 28 de noviembre, del Impuesto sobre la Renta de las Personas Fisicas y de modificacion parcial de las Leyes de los Impuestos sobre Sociedades, sobre la Renta de no Residentes y sobre el Patrimonio). The same would apply in the case that Germany introduces a similar regime."
37. Which is also contained in many other treaties; *see* in this respect, Beretta (2017), *supra* n. 9, at p. 441, fn. 31. As the author points out, some of the tax treaties that Italy has concluded, as well as some concluded by Switzerland, include provisions that restrict access to treaty benefits whereby foreign income is subject to special tax regimes in the residence state.
38. That is the case, for instance, of the tax treaties signed by Spain with the Republic of Singapore, Canada or China (People's Rep.).
39. *See* para. 8.
40. Art. 9 PIT regulations.


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

law.[41] *Stricto sensu* those tax regimes do not prevent the limitation of taxation on the income arising in the granting state but rather defer foreign income. Consequently, according to the wording of the second sentence in article 4(1), they are resident for treaty purposes. In this sense, the Commentary on Article 1 (2017)[42] recognizes that persons benefiting from remittance-based taxation, although taxed on income derived from sources outside the state, can qualify as residents insofar as this income is effectively repatriated, or remitted, thereto. For that reason, those states that want to exclude such individuals from the treaty's scope of application must deviate from the OECD Model and draft specific provisions to deny benefits in respect of income not remitted to the residence state. This is confirmed by the treaty practice of remittance-based regimes which, in some tax treaties, explicitly limit the relief to be allowed under the convention only to the income effectively remitted.[43] In short, assuming that the individual satisfies the requisites of the first sentence in article 4(1), as such person is "liable to tax" on some foreign-source income, the second sentence in article 4(1) does not apply to deny them treaty benefits.[44]

Finally, doubts could also arise regarding so-called flat tax regimes (adopted in other countries, such as Italy and Greece), according to which the taxpayer is entitled to the payment of a flat tax charge which applies in lieu of income tax. Also in relation are lump-sum tax regimes (adopted in Switzerland), which consist of an expenditure-based taxation for foreign nationals who are domiciled in the country but are not gainfully employed there. In this case, the tax is calculated based on the total annual cost of living expended by the taxpayers for themselves and their dependents in Switzerland and abroad. From the author's perspective, there are strong arguments to support that they are not excluded from the definition of "residence" analysed in this chapter. Firstly, these tax regimes tax foreign income and do so in lieu of the general individual income tax. Secondly, if we look into the US Model Tax Convention (US Model) (2016), it can be observed that it deviates from the OECD Model with regard to the second sentence in article 4(1).[45] In particular, it reads as follows: "[T]his term does not include any person whose tax is determined in that Contracting State on a fixed-fee, 'forfait' or similar basis, or who is liable to tax in respect only of income from sources in that Contracting State or of the profits attributable to a permanent establishment in that Contracting State."

In this respect, it has to be highlighted that the US Model provision is much broader in scope than that of the OECD/United Nations as it also excludes from the definition of "residence" any person whose tax burden is determined in that contracting state on a fixed-fee, "forfeit" or similar basis. Therefore, *sensu contrario*, from the analysis of the wording in the second sentence of article 4(1) of the OECD/UN Models, it might be affirmed that flat and lump-sum taxes are not excluded from the concept of residence.

Thirdly, many tax treaties signed by countries offering these special tax regimes contain specific clauses whereby the treaty benefits are only applicable under certain conditions. In particular, in the case of Switzerland, it is mentioned that the tax treaty applies if all income from sources in the other contracting state is taken into consideration for tax purposes.[46]

In conclusion, determining whether an individual benefiting from those special tax regimes is entitled to treaty benefits is not straightforward. It will depend, firstly, on the specific clause contained in the particular tax treaty in question and, secondly, if nothing specific is said in this respect, on the content and interpretation of article 4(1) and the characteristics of the special tax regime at hand. That said, it is possible to state that, if no special provision is provided for in the tax treaty concerned, in the vast majority of cases there are no difficulties in the application of the tax treaties to the individuals benefiting from the special tax regime analysed here. As a result, these taxpayers are in a very beneficial tax situation, as explained in the following section.

---

41. As noted in ch. 6 of this book, the Italian Supreme Court denied the resident status of res non-doms in the case concerning the singer Tiziano Ferro, despite the absence in the treaty of a specific provision that excludes those individuals benefiting from res non-dom special tax regimes. For a detailed analysis of this case, *see* P. Pistone & S. Messina, *Italy: Tiziano Ferro v. Agenzia delle entrate – Language (and Conceptual) Discrepancy?*, in *Tax Treaty Case Law Around the Globe 2021* (M. Lang ed., IBFD 2022), Books IBFD. On the contrary, the French Council of State has ruled that a taxpayer cannot be considered to lose UK tax residence solely because they are subject to the remittance-based treatment, as long as the objective of the UK remittance-based tax regime is not providing a definitive exemption of foreign-source income. Along the same lines, *see*, as an example, the Resolution of the Central Administrative Court (TEAC) of 11 July 2017 num. resolution 6469/2013, regarding the *UK-Spain Income and Capital Tax Treaty* (2013).
42. *See* para. 108.
43. *See*, for instance, the tax treaties signed by Ireland with the Kingdom of Spain (Protocol 2) and Italy (Protocol, art. 1(a)).
44. Dirkis, *supra* n. 13.
45. According to art. 4(1) *US Model*.
46. *See*, for instance, the *Can.-Switz. Income and Capital Tax Treaty* (1997), Treaties & Models IBFD, whose art. 4(5) reads as follows: "Where by reason of the provisions of paragraphs 1 and 2 an individual would be a resident of a Contracting State but is not subject in that State, with respect to all income generally taxable from sources from the other Contracting State, to the generally imposed income taxes, then such individual is not a resident of the first-mentioned State for the purposes of this Convention." In similar terms, *see also* art. 4(4) of the tax treaty signed with the Republic of Austria, art. 4(4) of the treaty signed with the Kingdom of Belgium, art. 4(6) of the treaty signed with the Federal Republic of Germany, art. 4(5)(b) of the treaty signed with the Republic of Italy, art. 4(4) of the treaty signed with the Kingdom of Norway or art. 4(5) of the *Switz.-US Income Tax Treaty* (1996), Treaties & Models IBFD, which expressly states: "An individual who would be a resident of Switzerland by reason of the provisions of paragraphs 1 and 3, but who elects not to be subject to the generally imposed income taxes in Switzerland with respect to all income from sources in the United States, shall not be considered a resident of Switzerland for the purposes of this Convention."


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

### 7.2.2.2. Special tax regimes to attract individuals and (double) non-taxation

Setting aside the discussion on the entitlement to tax treaty benefits, and departing from those scenarios in which the residence requirements are fulfilled and the tax treaty applies, the very beneficial tax position of expatriates shall be highlighted for several reasons.[47]

Firstly, the inbound expatriate benefits from the special tax regime granted by the new state of residence (host state) which, in most cases, does not tax the individual on the majority of their foreign-source income. Thus, the inbound expatriate is in a significantly better position than the residents of the new state in terms of tax actually paid to the host state.[48]

Secondly, the inbound expatriate is subject to significantly reduced taxation in the former state of residence (home state) due to the restriction of (source) taxation provided for in the tax treaty. In fact, as long as the inbound expatriate is a resident of the host state for tax treaty purposes, the home state is entitled to claim tax only on source income and to the extent provided for in the treaty.[49]

As already mentioned, sometimes special tax regimes grant inbound expatriates lower taxation and even offer them an option to be taxed similarly to non-residents. Thus, in those cases, some types of income will not be subject to tax leading to a non-taxation situation (double non-taxation). In fact, that might be the case if, according to the specific tax treaty, a type of income (in particular, business profits, dependent personal services income, pensions and uncategorized income) is subject to tax exclusively in the state of residence, which exempts that type of income from taxation due to a special tax regime, and the other contracting state (the source state) is not entitled to tax such income.

The above-mentioned situation has occurred particularly in relation to pensions. The Portuguese non-habitual resident tax regime and its interaction with pension income and tax treaties provide a good example of that. Under the Portuguese regime, among other types of foreign income, pensions were not taxed in the state of residence (since the amendment introduced in 2020, these pensions are taxed at a 10% rate)[50] by applying the special tax regime for non-habitual residents. In particular, if pensions received by Portuguese residents came from the country of origin of the Portuguese non-habitual resident (home country) and their pension fell under the scope of the equivalent provision of article 18 of the OECD Model, exclusive taxing rights were granted to the state of residence (host country). As a result, the income obtained was either not taxed or it was taxed at a low rate. The same holds true for other jurisdictions known for their preferential tax regimes, such as Italy or Israel.[51]

Taxation of pensions and their interaction with tax treaties is much more complex but, in most cases, it is possible to argue that the underlying problem in this discussion is mainly a tax policy issue rather than a legal or technical one. The OECD Commentary on Article 18 (2017)[52] refers to the possible mismatches that could arise in different scenarios and contains provisions that states are free to bilaterally agree, for example the subject-to-tax clause, to distinguish between cases where the residence state taxes pension income and where it does not. States are already aware of the eventual inbound expatriate regime and the possibility that the convention may lead to non-taxation situations when they sign a tax treaty. If they are not, because such a regime has not yet been approved, they should at least be aware that it can be approved at any time thereafter and that this type of situation may arise. Consistently, the reaction of some states that have intended to tackle this situation has been to renegotiate the tax treaty and to modify the taxation of such types of income by including different methods of source taxation or even to terminate the tax treaty.[53]

---

47. Described by Sharkey, *supra* n. 23.
48. As a consequence of that, inequality problems arise that are outside the scope of this chapter. *See* on that issue, from a domestic Spanish perspective, Báez Moreno & López López, *supra* n. 7.
49. In this respect, and according to the *OECD Model* (2017):

 - business profits are not taxable in the home state, unless they can be attributed to a permanent establishment in the home state, through which the individual carries on business;
 - dividends are only taxable if paid by a home state company and only at a low rate of tax;
 - interests are only taxable in the home state if they arise there and such tax is limited to a low rate;
 - although the tax treaty practice does not follow the Model, royalties are only taxable by the host state;
 - profits from property and its alienation are only taxable if the property is in the home state;
 - dependent personal services income is only taxable in the host state, unless the person works in the home state and remains there for a lengthy period, or paid by a home state entity or attributed to a home permanent establishment; and
 - uncategorized income is only taxable in the host state.
50. At the time of publication, the President of Portugal announced the abolition of the non-habitual resident regime as of 1 Jan. 2024.
51. *See* the recent ruling of FR: Administrative Court of Toulouse, 13 Oct. 2022, num. N° 20TL22832.
52. *See* paras. 8-21.
53. As in the cases of tax treaties between Portugal and Finland, Spain and Denmark or France and Denmark.


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.

Although exclusive residence-based taxation, as the relevant taxing rule, is mandated by article 18 of the OECD Model and a series of justifications for its adoption can be found, actual tax treaty practice shows that allocating taxing rights to the source state is equally possible and that the tendency to attribute at least some private pension income taxing rights to the source state is indeed growing, in particular, among pension-exporting nations like the northern countries in the European Union.[54]

Similar issues arise regarding income from employment and, in particular, in the case of remote workers and the so-called "digital nomads" as discussed in chapter 4 of this book. As a consequence of the current allocation rule provided for in article 15 of the OECD/UN Models, which – as a general rule – establishes exclusive taxation rights in the state of residence unless the employment is carried out in the other contracting state and at least one of the three requirements is fulfilled,[55] many scenarios of (double) non-taxation will arise. This may be the case insofar as, on the one hand, the individual is resident in a country that provides for no or limited taxation on foreign income and, on the other hand, the source state is not entitled to tax such income.

In conclusion, when a taxpayer fulfils the residence requirements (which have been examined in the previous sections) set out in article 4, it is logical to consider that a low or non-taxation situation might arise as a consequence of applying the allocation rules provided for in the tax treaty and the special tax regime. Moreover, this situation might be even desired by the signatory states or, at least, by one of them, i.e. those situations in which double non-taxation is the logical outcome of legitimate and sovereign policy choices by states and the intended result of an individual's relocation to the other jurisdiction falls outside the scope of a tax treaty and cannot be overturned unilaterally by one of the two states.[56]

The legal outcome might be different if a country can be regarded as structuring its tax rules to deliberately allow taxpayers to exploit international tax instruments, particularly tax treaties. As a result of the operation of tax treaties, opportunities for international tax minimization at the expense of other jurisdictions would be allowed. From these opportunities, technical issues related to tax planning, tax avoidance and tax evasion might arise. However, such issues are, again, analysed in a separate chapter (*see* chapter 8).

## 7.3. Conclusions

The increasing mobility of highly skilled workers and HNWIs is being further encouraged by more and more states which, in a race to the bottom to incorporate beneficial tax regimes into their tax systems, seek to attract them or prevent them from leaving. This chapter has discussed the interaction of those special tax regimes with tax treaties and, more specifically, the entitlement issues.

There is no issue regarding the compatibility of domestic tax benefits to retain certain individuals with tax treaties, provided that the state that grants the tax benefit extends it to the nationals of all states with which it has signed tax treaties.

A more challenging question is the compatibility of special tax regimes to attract individuals with tax treaties. It is impossible to offer a unique or immediate answer on that issue. In fact, as it has been demonstrated in this chapter, the answer to this question depends, firstly, on the specific clause contained in the particular tax treaty in question and, secondly, on the content and interpretation of article 4(1) and the characteristics of the special tax regime at hand. If no special provision is provided for in the tax treaty concerned, in the vast majority of cases, there are no difficulties when applying the tax treaties to the individuals benefiting from the special tax regime analysed here. As a result, these taxpayers are in a very advantageous tax position. Indeed, in the interaction between those special tax regimes and tax treaties, many scenarios of non (or low) taxation will arise. Those situations are the logical outcome of legitimate and sovereign policy choices by states and the intended result from the relocation of an individual in the other jurisdiction, and these fall outside the scope of a tax treaty and cannot be overturned unilaterally by one of the two states.

---

54. *See* G. Beretta, *Fixing the Social Contract: A Blueprint for Individual Tax Reform*, Annals of the Belgrade Law Review 4 (2019).
55. (i) the recipient is present in the other state for a period or periods in the aggregate of 183 days or more within any period of 12 months; (ii) the remuneration is paid by, or on behalf of, an employer who is a resident of the other state; or (iii) the remuneration is borne by a permanent establishment which the employer has in the other state.
56. Beretta (2018), *supra* n. 9, at sec. 5. As this author points out: "'Fair taxation' is not in fact among the aims of a tax treaty. A tax treaty primarily allocates taxing rights among the contracting states, also ensuring that this allocation is not abusive. 'Fair taxation', as a goal, is only relevant from a purely domestic perspective of a country, whether it acts as the emigration or immigration country. Thus, the introduction of a preferential tax regime by a country to encourage individuals to immigrate and invest in its territory may be questioned on the grounds of consistency with, for instance, the equality and ability-to-pay principles as stipulated under that domestic tax system, but it can by no means lead to subverting the allocation of taxing rights as agreed upon bilaterally in a tax treaty."


© Copyright 2024 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.

Exported / Printed on 18 Sep. 2024 by IBFD.