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Araştırma Makalesi (Research Article)

Taxation of Deemed Income in Treaty Law: A Comparative Analysis and Case Study

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Abstract

This article deals with the treatment of transfers of use without consideration in treaty law (double taxation convention/DTC), using the example of interest and royalties. Compared to an interest-bearing loan or licensing for consideration, the free transfer of use under the current DTC rules can lead to a distortion of the allocation of taxation rights between the Contracting States and potential tax losses in the source state. This article analyses this issue for the first time, including examples. To illustrate the analysis, a case study is included. The purpose of the study is to identify shortcomings of the current DTC rules concerning the taxation of deemed income from the free transfer of use in the state of residence of the borrower or licensee (referred to as the source state in this article) against the granting person. Another objective of the study is to derive solutions for the further development of DTC law to ensure adequate taxation of the free transfer of use in the source state. This study aims to improve the current DTC law.

Keywords: Treaty Law, Double Tax Convention, OECD Model Tax Convention on Income and on Capital, International Law, Tax Law, Taxation.

JEL Codes: K34, K33.

Anlaşma Hukukunda Varsayılan Gelirin Vergilendirilmesi: Karşılaştırmalı Bir Analiz ve Vaka Çalışması

Öz

Bu makale, anlaşma hukukunda (Çifte Vergilendirmeyi Önleme Anlaşması/Çifte Vergileme Anlaşması) kullanımın ivazsız devrine ilişkin muameleyi, faiz ve isim hakkı örneklerini kullanarak ele almaktadır. Faizli kredi veya bedelli lisans ile karşılaştırıldığında, mevcut ÇVÖ kuralları kapsamında kullanımın bedelsiz devri, akit devletler arasında vergilendirme haklarının dağılımında bir bozulmaya ve kaynak devlette potansiyel vergi kayıplarına yol açabilir. Bu makale, örneklerle birlikte bu konuyu ilk kez analiz etmektedir. Çalışmanın amacı, borç alanın veya lisans sahibinin mukim olduğu devlette (bu çalışmada kaynak devlet olarak anılacaktır) kullanımın karşılıksız devrinden doğduğu kabul edilen gelirin borç verene göre vergilendirilmesine ilişkin mevcut ÇVÖ kurallarının yetersizliklerini vurgulamaktır. Çalışmanın bir diğer amacı da kaynak devlette bedelsiz kullanım devrinin yeterli şekilde vergilendirilmesini sağlamak üzere hukukunun daha da geliştirilmesi için çözümler üretmektir. Bu çalışma mevcut ÇVÖ yasasını geliştirmeyi amaçlamaktadır.

Anahtar Sözcükler: Antlaşma Hukuku, Çifte Vergilendirmeyi Önleme Anlaşması, OECD Gelir ve Sermaye Üzerinden Alınan Vergilere İlişkin Model Anlaşması, Milletlerarası Hukuk, Vergi Hukuku, Vergilendirme.

JEL Kodları: K34, K33.

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1. INTRODUCTION

This article addresses whether shortcomings exist in current DTC law concerning the taxation of deemed interest income from a cross-border interest-free loan by the source state. So far, this question has neither been raised nor examined in the literature (Lang, 2021, Reimert and Rust, 2022, Pistone et all, 2008, Lang, 2001, Rosha, 2022, Haslehner, 2022, Teixeira, 2009). Therefore, this article breaks new ground. Substantial shortcomings in DTC law may result from the change in the definition of interest income in Article 11 (3) from Model Tax Convention (MTC) 1963 to MTC 1977. This is because Article 11 (3) MTC 1963 does not contain a conclusive definition of the term interest, but a general clause and also covers income that is treated as income from loans under the domestic law of the Contracting State from which it originates (OECD MC, 1963). In contrast, Article 11 (3) changes from the MTC 1977 to a conclusive, treaty-autonomous definition of interest and no longer contains a supplementary reference to the domestic law of the Contracting States (OECD MC, 1963, OECD MC, 1977). Thus, the definition of interest in Article 11 (3) MTC 1977 is more narrowly defined than in MTC 1963. The same applies to the definition of interest in Article 11 (3) MTC 2008/2014/2017. Furthermore, this narrower definition of interest in Article 11 (3) as of MTC 1977 does no longer cover income that is only taxed as interest under the domestic tax law of the Contracting State from which it originates, but which does not fall under the treaty-autonomous definition in Article 11 (3) (OECD MC, 1977). Such income may, for example, be deemed interest income from a loan granted without interest or at a reduced rate. Accordingly, the source state of the deemed interest income in the case of an interest-free loan could be prevented from taxing this income under treaty law. This is examined below. To illustrate the analysis, a case study is included.

Furthermore, the lack of effectiveness of the current DTC law regarding the taxation of deemed interest income is examined (Article 9, Article 11 MTC). In addition, the allocation of taxation rights between the Contracting States under treaty law is discussed in the case of deemed interest income from an interest-free loan. In this respect, the distortion of taxation compared to an interest-bearing loan is shown, which is mainly due to the changed definition of interest in Article 11 (3) since the 1977 MTC. Finally, legal solutions for the further development of DTC law are discussed and tested concerning the taxation of deemed interest income. Since the basic problem applies accordingly to royalties (Article 12 MTC) and generally, to the transfer of use without consideration, great relevance can be observed.

2. INTEREST-FREE LOAN AND DEEMED INTEREST INCOME: A CASE STUDY

The parent company (M) is a resident of Contracting State A. It has a 100% shareholding in its subsidiary (T). M has permanent establishments (PE) exclusively in Contracting State A. The subsidiary (T) is resident in Contracting State B and has its permanent establishments exclusively in that State. Both operate an enterprise within the meaning of treaty law according to Articles 5 and 7 MTC. There is a double taxation agreement between State A and State B following MTC 1977/2008/2014/2017. The parent company (M) granted the subsidiary (T) a non-interest-bearing loan of 10 million euros at an interest rate of 0%. The arm's length interest rate would be 5%. The situation can be depicted as follows (Figure 1):

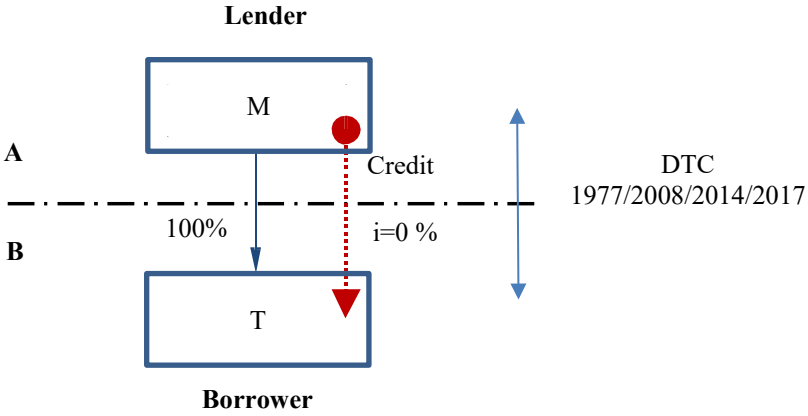

Figure 1. Loan without consideration and taxation of deemed interest income by source state B.

The question arises of how the interest-free loan is treated under DTC law. In particular, it is a question of whether the source state of the deemed interest income (here state B) has a right to tax this income under treaty law.

According to Article 9 MTC, M and T are related companies. Concerning the business relationship between M and T, and the granting of the loan, the agreed conditions differ from those that would have been agreed between independent third parties. Instead of M as the lender, an unrelated third-party lender would have granted the loan of €10 million not at an interest rate of 0%, but at the market rate of 5%. Under Article 9 (1) MTC, Contracting State A may therefore add a profit of €500,000[1] ("deemed interest income") to M's profit and tax it according to Article 7 (1) MTC. According to Article 9 (2) MTC, Contracting State B has to make a profit adjustment of € 500,000 regarding the taxation of borrower T under Article 7 MTC. As a result of Article 9 (2) MTC, Contracting State B reduces the profit of company T by € 500,000 ("deemed interest expenses"). Article 9 (2) exclusively concerns the taxation of the borrowing subsidiary T by Contracting State B.

However, the question arises whether Contracting State B may also tax the lender M with deemed interest income (here € 500,000) according to DTC law. This is because interest income in the same amount would have accrued if the loan had been granted for consideration. In this case, Contracting State B could have taxed lender M on the actual interest income under Article 11 (2) MTC with a withholding tax of up to 10% of the gross amount of the interest. Considering the borrower T, State B would have had to allow a tax-reducing interest deduction for taxation under Article 7 (1) MTC. In the overall view, in the case of an interest-bearing loan at market rates, the interest deduction at the level of the borrowing company T (Article 7) is partially compensated by a withholding tax on the corresponding interest income against the lender M (Article 11).

Concerning the present non-interest-bearing loan and deemed interest income, it is questionable whether source State B can tax the deemed interest against the lender M, resident in Contracting State A, within the framework of Article 11 (2) MTC or not. This must first be examined against the background of the applicable MTC 1977/2008/2014/2017 and the definition of interest income there (initial situation). This is followed by a comparative analysis under the MTC 1963 with a different definition of interest income in Article 11 (3). That is the comparative case. By comparing both situations, conclusions can be drawn regarding the taxation of deemed interest income under treaty law in the source state (here Contracting State B). Moreover, the effects of the changed interest definition from MTC 1963 to MTC 1977/2008/2014/2017 on the distribution of taxation rights under treaty law can be illustrated. If the source state B in the case of a non-interest-bearing loan has no

[1] €10 million x 5% = 500,000 € (deemed interest income).

taxation right on the deemed interest income under treaty law, a loss of tax revenue occurs compared to a loan granted at the market rate of interest. Both forms of loan would be treated differently under tax treaty law.

Accordingly, the question arises whether Article 9 MTC gives the source state (Contracting State B) a right to tax the deemed interest income against the lender M resident in Contracting State A in the case of an interest-free loan. Since the content of Article 9 MTC was not changed from MTC 1963 to the current MTC 1977/2008/2014/2017 – unlike Article 11 (3) MTC – this article will be analyzed first. After that, it is investigated whether source State B has a right to tax the deemed interest income under Article 11 MTC 1977/2008/2014/2017.

3. CAN THE SOURCE STATE TAX DEEMED INTEREST INCOME UNDER ARTICLE 9 MTC?

Is the source state B able to tax the deemed interest income from the non-interest-bearing loan against lender M, who is a resident of the other Contracting State A, according to Article 9 MTC? All transactions between associated enterprises deviating from the arm's length principle, at above or below the market price, are covered by Article 9 MTC.

Article 9 (1) MTC allows the profit of an enterprise that was reduced by the non-market transaction between associated enterprises to be increased to the market price, and to be taxed by the Contracting States in line with Article 7 MTC (profit attribution) (Lang, 2021: 110). In the case of transactions above the market price, Article 9 (1) MTC refers to the company receiving the service whose profit was reduced by this overcharge (e.g. excessive operating expenses in the case of consultancy services received). In the case of a transaction below the market price, Article 9 (1) DTA refers to the supplying enterprise, since its profit is reduced accordingly (e.g. granting of a loan at an interest rate below the market rate). In the present case of the non-interest-bearing loan, the profit of company M as the lender is reduced. Company M is resident in Contracting State A and only has permanent establishments there within the meaning of Article 5 MTC. According to Article 7 (1) MTC in conjunction with Article 9 (1) MTC, Contracting State A may increase and tax the profit of company M by the deemed interest income.

Can Contracting State B tax company M (lender), which is a resident of the other Contracting State A, with the deemed interest income according to Article 9 (1)? This must be answered in the negative, since company M has no permanent establishment in Contracting State B and therefore may not be taxed in State B according to Article 7 (1) MTC. Taxation according to Article 9 (1) MTC requires that the relevant Contracting State has a right of taxation on profits of the company according to Article 7 MTC whose profits are increased. However, according to Article 7 (1) MTC, Contracting State B has no right to tax the profits of company M resident in Contracting State A due to the lack of a permanent establishment on its territory. Consequently, source State B cannot tax the deemed interest income according to Article 9 (1) MTC.

Article 9 (2) MTC concerns the counter-adjustment to an adjustment of profits according to Article 9 (1) MTC and is thus intended to avoid economic double taxation (Lang, 2021: 110, Kofler, 2016: 588). In the case of the non-interest-bearing loan in question, this regulation does not refer to the taxation of the company granting the loan, M, but to the borrower, T. Since the profit of the company granting the loan, M, was increased in Contracting State A (deemed interest income), the profit of the company borrowing the funds, T, must be reduced in Contracting State B in line with Article 9 (2) MTC (deemed interest expenses). Compared to the case of a loan with interest at market rates, the profit of the borrower T is too high. Contracting State B must reduce the profit of the borrower T by deemed interest expenses, taking into account the other provisions of the DTC, Article 9 (2) S. 2 MTC. Nevertheless, this does not allow Contracting State B to tax the lender M, who is a resident of the other Contracting State A, with the deemed interest income under Article 9 (2) MTC. For this, the requirements of Article 11 DTA would have to be fulfilled in any case (other provisions of the DTC; see point 4). This also applies to a possible secondary adjustment in connection with the

interest-free loan by Contracting State B if this state recognizes deemed interest income due to a transfer price-related interest claim (Teixeira, 2009, Foley, 2022). This is not excluded by Article 9 (2) MTC (OECD, 2017). However, in the case of a secondary adjustment, taxation by Contracting State B must be within the limits of the DTC (Teixeira, 2009). Article 9 (2) MTC only concerns a reducing counter-adjustment at the borrower level (here T) (Lang, 2021, Teixeira, 2009). The source state B can not tax the deemed interest income relating to the non-interest-bearing loan under Article 9 (2) MTC.

Overall, in the present case (Figure 1), source state B can not tax the deemed interest income from the non-interest-bearing loan under Article 9 MTC.

4. CAN THE SOURCE STATE TAX DEEMED INTEREST INCOME UNDER ARTICLE 11 MTC 1977/2008/2014/2017?

It must be examined whether the source State B can tax the deemed interest income from the interest-free loan according to Article 11 MTC 1977/2008/2014/2017 against the lender M, resident in Contracting State A. For this, two conditions must be fulfilled cumulatively. First, interest must exist according to the definition of Article 11 (3) MTC. In addition, this interest must be paid within the meaning of Article 11 (1) MTC by the borrower T resident in State B to the lender M resident in Contracting State A.

Article 11 (3) MTC 1977/2008/2014/2017 defines interest autonomously and without reference to the domestic law of the Contracting States as income from claims of any kind for the provision of capital (OECD MC, 1977, Lang, 2021: 72). Consequently, remuneration for the use of borrowed capital must have been agreed upon and must exist. This is not the case here. Under civil law, the lender M does not have an interest claim or a user fee for the transfer of the capital, since the lender granted the loan without interest. In the case of an interest-free loan, there is no debtor and creditor of remuneration for use (interest). Interest within the meaning of Article 11 (3) MTC 1977/2008/2014/2017 is any amount paid by the debtor to the creditor (principal) over and above the repayment of the principal amount owed (OECD MC, 1977). Such payments by the borrower T to the lender M do not exist in the present case of an interest-free loan. T only pays back the capital granted to M (repayment of the basic amount) and no further amounts beyond that. Consequently, the deemed interest income of the lender M from the interest-free loan does not constitute interest within the meaning of Article 11 (3) MTC 1977/2008/2014/2017.

The definition of interest under Article 11 (3) MTC 1977/2008/2014/2017 does not contain a reference to the domestic law of the source State, as Article 11 (3) MTC 1963 does (OECD MC, 1977). Even if the deemed interest income were to qualify as interest income under the domestic tax law of source State B, or were to be equated with income from loans in this respect, this does not lead to the existence of interest within the meaning of Article 11 (3) MTC 1977/2008/2014/2017 for DTC application. According to Article 11 (3) MTC 1977/2008/2014/2017, there is no interest if the income in question is only qualified as interest under the domestic law of the source state, but is not covered by the conclusive definition in Article 11 (3) MTC (OECD MC, 1977).

Thus, it can be stated that the deemed interest income of the lender M from the interest-free loan is not interest within the meaning of Article 11 (3) MTC 1977/2008/2014/2017. Accordingly, the interest article does not apply to this income, even if the domestic tax law of source state B treats the deemed interest as income from loans for tax purposes (e.g. via a transfer pricing-related secondary adjustment by recognising deemed interest income and a transfer pricing-related interest receivable). The further requirement of Article 11 (1) MTC, the cross-border payment of interest by a resident of a Contracting State to a resident of the other Contracting State, is therefore no longer relevant. In any case, according to Article 11 (1) MTC 1977/2008/2014/2017, there should also be no payment of interest, since the borrower T does not pay any amounts to the lender M that go beyond the repayments of the capital granted.

Article 11 (6) MTC does not change the inapplicability of the interest article here either. This

provision only covers excessive interest payments that deviate from the arm's length principle. The wording of Article 11 (6) MTC stipulates as a prerequisite for the application that the interest, measured against the underlying claim, exceeds the amount that would have been agreed by third parties (reasonable interest) in comparison to the excessive interest agreement of the related parties. The legal consequence of the regulation is that Article 11 MTC only applies to the amount of reasonable interest regarding the loan relationship of the related parties. The exceeding amount of interest, i.e. the excessive part of the interest in terms of amount, can be taxed by each Contracting State according to its domestic law, taking into account the other provisions of the DTC (e.g. Article 9 or Article 10 MTC in the case of the assumption of a hidden profit distribution concerning the excessive amount of interest). In the present case, however, there is a non-interest-bearing loan, so there is already no case of Article 11 (6) MTC.

As a result, it can be stated that source State B can not tax the deemed interest in connection with the interest-free loan granted by the lender M resident in the other Contracting State A to its subsidiary and borrower T resident in the source State B by Article 11 MTC 1977/2008/2014/2017. This is the current legal situation under DTC law. The interest article is generally not relevant in such a situation. The deemed interest income is not mentioned in the allocation articles 6 to 20 MTC (Lang, 2021: 73). According to Article 21 (1) MTC, the deemed interest income can only be taxed in the state of residence A of the lender M. Moreover, lender M does not have a permanent establishment within the meaning of Article 5 MTC in Contracting State B to which its loan claim would belong. This requirement of Article 21 (2) MTC is not met in the present case. Thus, the deemed interest income can only be taxed in Contracting State A, the state of residence of the lender M.

5. CAN THE SOURCE STATE TAX DEEMED INTEREST INCOME UNDER THE APPLICATION OF ARTICLE 11 (3) MTC 1963? – HYPOTHETICAL COMPARATIVE ANALYSIS

In a hypothetical comparative analysis, the question arises whether source State B could tax the deemed interest income from the interest-free loan against the lender M resident in the other Contracting State A, if the definition of interest under Article 11 (3) MTC 1963 would be applicable instead of the definition under Article 11 (3) MTC 1977/2008/2014/2017.

Under Article 11 (3) MTC 1963, the concept of interest under treaty law also includes income that is treated as income from loans under the law of the Contracting State from which it originates (OECD MC, 1963).

According to Article 11 (3) MTC 1963, the lender M resident in Contracting State A would receive interest within the meaning of Article 11 MTC, since the deemed interest income is considered to be interest by the domestic tax law of the source state B. Furthermore, in such a case, the requirement of Article 11 (1) MTC should also be fulfilled that the (deemed) interest is paid by a resident of a Contracting State, here the borrower T, who is a resident of Contracting State B, to the lender M, who is a resident of the other Contracting State A. The term "pay" in Article 11 (1) MTC 1963 can also include an attribution of income according to the domestic tax law of a Contracting State (OECD MC, 2017, Lang, 2021: 72). Moreover, with the treaty-autonomous definition of interest according to the domestic tax law of the source state under Article 11 (3) MTC 1963, a (deemed) creditor or beneficial owner and debtor may have been determined at the same time, which is also governed by the domestic law of the source state.

Subject to Article 11 (3) MTC 1963, the source State B of the deemed interest income in the case of an interest-free loan and any income correction under its domestic law (e.g. recognition of deemed interest income against the lender using a transfer price correction or secondary adjustment) may tax the lender M resident in the other Contracting State A with the deemed interest income under Article 11 MTC. According to Article 11 (2) MTC, the source State B may levy a withholding tax of up to 10% of the gross amount of the deemed interest. In this way, the source state B can (partially) compensate the deduction of deemed interest expenses according to Article 9 (2) MTC regarding the

primary counter-adjustment at the level of borrower T concerning the interest-free loan. Accordingly, source State B can tax the deemed interest income against the lender M resident in Contracting State A by Article 11 (2) MTC.

Thus, under the application of Article 11 (3) MTC 1963, the same result is achieved regarding the distribution of taxation rights between the Contracting States as if the loan had not been granted interest-free, but at a market interest rate. Source State B can tax the deemed interest income according to Article 11. The interest article does not prevent source state B from taxing deemed interest from a (secondary) transfer pricing adjustment against a lender resident in the other Contracting State. Concerning source State B of the deemed interest income, there is no tax loss. According to Article 9 (2) MTC, this state is in principle obliged to make a primary counter-adjustment at the level of the borrowing company but can tax the deemed interest income against the lender M resident in the other Contracting State according to Article 11 (3), (2) MTC 1963.

However, the situation is different if Article 11 (3) MTC 1977/2008/2014/2017 applies. In this case, source State B can not tax the deemed interest income under Article 11 (see point 4). Due to Article 11 (3) MTC 1977/2008/2014/2017, the source State B is prevented from taxing the deemed interest income. Nevertheless, based on Article 9 (2) MTC, the source State B must grant primary counter-adjustment ("deemed interest deduction") in the case of the interest-free loan at the level of the borrower T. Overall, there is a tax loss for the source state B. Furthermore, there is a shift in the allocation of taxation rights under treaty law between the contracting states in comparison to a loan granted at market interest rates. In the case of a loan at market interest rates, the source State B would have been able to tax the interest income at 10% withholding tax under Article 11 MTC 1977/2008/2014/2017. Furthermore, in such a case, the source State B would in principle have to grant an interest deduction at the level of the borrower T.

In other words, the change from the interest definition under Article 11 (3) MTC 1963, which contains a supplementary reference to the domestic law of the source state, to the interest definition under Article 11 (3) MTC 1977/2008/2014/2017, which defines the term interest autonomously under the treaty without recourse to domestic tax law, leads to an inappropriate shift of taxation rights under treaty law between the contracting states and potential tax losses for the source state. The interest-free loan is affected (see Figure 1). This change in the definition of interest under treaty law leads to tax losses for the source state B. It prevents source state B from taxing transfer pricing adjustments in the form of deemed interest income against a lender resident in the other Contracting State under treaty law. At the same time, this change in the definition of interest means that non-interest-bearing loans with transfer price adjustments (Article 9 MTC) are not taxed like loans with interest at market rates, which was guaranteed before under Article 11 (3) MTC 1963.

Consequently, an adjustment and further development of DTC law are required to ensure a balanced allocation of taxation rights at the treaty level and to limit tax losses in the source state. Possible solutions are discussed in the following paragraph.

6. FURTHER DEVELOPMENT OF DTC LAW – A NEW VERSION OF ARTICLE 21

Since the current DTC law (MTC 1977/2008/2014/2017) does not ensure effective taxation of interest income in the source state, further development is needed. In general, deemed interest income arising in the case of interest-free loans from a transfer pricing adjustment by the Contracting State of the borrower (source state) against the lender resident in the other Contracting State is affected.

Furthermore, this problem applies accordingly to royalties under Article 12 DTC. According to Article 12 (1) MTC, royalties can only be taxed in the country of residence of the licensor or beneficial owner. However, the bilateral DTCs often differ and grant the source state a limited withholding tax deduction concerning the royalties (DTC Bulgaria-USA 5%; DTC UK-Luxembourg 5%; DTC UK-Uganda 15%; DTC France-Korea 10%; DTC France-Switzerland 5%). In the case of royalties, too, Article 12 (3) MTC provides a definition that does not refer to the national tax law of the source state. Consequently, in the area of royalties according to Article 12 MTC, there is also the

problem that the source state can not tax transfer price adjustments in the case of free or reduced-price transfers of use to licensors and service providers who are resident in the other contracting state. Article 12 (4) MTC, like Article 11 (6) MTC, only covers the case of excessive remuneration. The lack of effectiveness of the current DTC law about the taxation of deemed income from the free or reduced-price transfer of use in the source state represents a global and fundamental problem. Consequently, a universal solution is necessary. Thus, in addition to interest (Article 11 MTC), royalties according to Article 12 MTC are also affected.

One possible solution is for contracting states to expand the definition of interest under Article 11 (3) and the definition of royalties under Article 12 (3) in bilateral DTCs to include income that is taxed as interest or royalties under the domestic tax law of the source states. On the one hand, this requires the bilateral adaptation of the respective DTCs. On the other hand, this is not a universal solution to the problem of the lack of effectiveness of current DTC law regarding the taxation of deemed income from the gratuitous transfer of use in the source state. Moreover, concerning interest, this would be a return to the definition of interest under Article 11 (3) MTC 1963. It could also be questionable whether this solution can effectively cover all cases of gratuitous transfer of use. However, there are also cases in which the national law of the source state merely makes deemed income from the free transfer of use taxable, but does not tax it in the same way as income from interest or licences.

A universal solution to the lack of effectiveness of the current DTC law regarding the taxation of deemed income from free or reduced transfer of use in the source state is to add a paragraph 3 to Article 21 DTC/MTC and to include a modified provision under Article 20 (3) DTC Australia-Germany 2016. Article 20 (3) DTC Australia-Germany (Other Income) reads:

"*Notwithstanding paragraphs 1 and 2, the income of a resident of a Contracting State from sources in the other Contracting State not dealt with in the preceding Articles may also be taxed in the other Contracting State*".

This rule generally allows income from the source state that is not mentioned in the aforementioned articles to be taxed in the source state. However, concerning interest and royalties as well as a desired withholding tax in the source state in the case of deemed income from the free or reduced transfer of use, this regulation could have an excessive effect. Consequently, it must be modified. A regulation on the effective recognition of deemed income from the gratuitous transfer of use of loans and licence rights in the source state could therefore be formulated as follows and embedded in a newly worded Article 21 (Other income):

Article 21 Other income (new version)

(1) Income of a resident of a Contracting State which has not been dealt with in the preceding Articles shall, regardless of its source, be taxable only in that State.

(2) 1Paragraph 1 shall not apply to income other than income from immovable property referred to in paragraph 2 of Article 6 received by a resident of a Contracting State who carries on business in the other Contracting State through a permanent establishment situated therein to which the rights or assets in respect of which the income is paid effectively belong. 2In this case, Article 7 shall apply. 3*However, where the income includes dividends paid by a company which is a resident of the first-mentioned State or interest or royalties derived from that State, the income may be taxed in that State at the rates provided for in Articles 10 (2), 11 (2) and 12 (2) respectively.*

(3) *1Notwithstanding paragraphs 1 and 2, the income of a resident of a Contracting State from sources in the other Contracting State not dealt with in the preceding Articles may also be taxed in the other Contracting State. 2****In the case of income which, under the law of the Contracting State from which it arises, is treated for tax purposes as income from interest or royalties, Article 11 and Article 12 shall apply mutatis mutandis. 3This income may be taxed in this State at the rates provided for in Article 11 (2) and Article***

12 (2) respectively, unless the conditions of Article 11 (6) and Article 12 (4) are met respectively. 4Article 21 (2) shall apply mutatis mutandis to income within the meaning of sentence 2 under the conditions specified therein.

Finally, the new Article 21 DTC can be tested concerning the taxation of deemed interest income in the case of an interest-free loan by source State B (Figure 1). The lender M resident in Contracting State A has granted an interest-free loan to its borrower T (subsidiary) resident in Contracting State B. The interest-free loan is taxable in Contracting State A. The loan is taxable in Contracting State B.

According to the domestic tax law of source state B, deemed interest income is attributed to the lender M from this transaction (transfer pricing-related secondary adjustment).

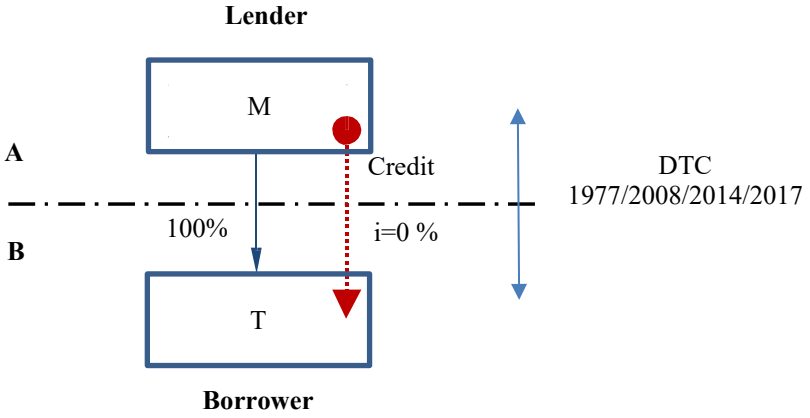

Figure 2. Application of Article 21 new version to the free transfer of use (interest) and taxation of deemed interest income in source state B

According to Article 11 (3) MTC 1977/2008/2014/2017, the deemed interest income does not constitute interest within the meaning of Article 11 MTC. Rather, this income of the lender in Contracting State B falls under Article 21 MTC (Other income). According to Article 21 (3) sentence 1 MTC, this income can be taxed in source State B. According to Article 21 (3) sentences 2 and 3 MTC in connection with Article 11 (2) MTC, the source State B may levy a withholding tax of up to 10% of the deemed interest income. Taking into account further taxation (Article 9 MTC, see point 3.), the interest-free loan with primary and secondary transfer price adjustment is taxed under treaty law in the same way as an interest-bearing loan. About source state B, there is no longer any loss of taxation. The new version of Article 21 DTC/MTC presented here, therefore, provides adequate taxation results. It enables the appropriate allocation of taxation rights under treaty law between the contracting states in the case of free or reduced transfers of use.

The new version of Article 21 DTC/MTC on the taxation of free or reduced transfers of use in the source state is to be tested in a further application case. In this case, company M is a resident of Contracting State A. It has a permanent establishment in the other Contracting State B within the meaning of Article 5 MTC. Via this permanent establishment, company M grants an interest-free loan to company T (subsidiary). Company T is also a resident of Contracting State A. The question is whether Contracting State A can tax deemed interest income from the granting of the interest-free loan under treaty law against the lender M? According to the national tax law of Contracting State A, lender M earns deemed interest income from a transfer pricing-related secondary adjustment. Graphically, the facts of the case are as follows (Figure 3):

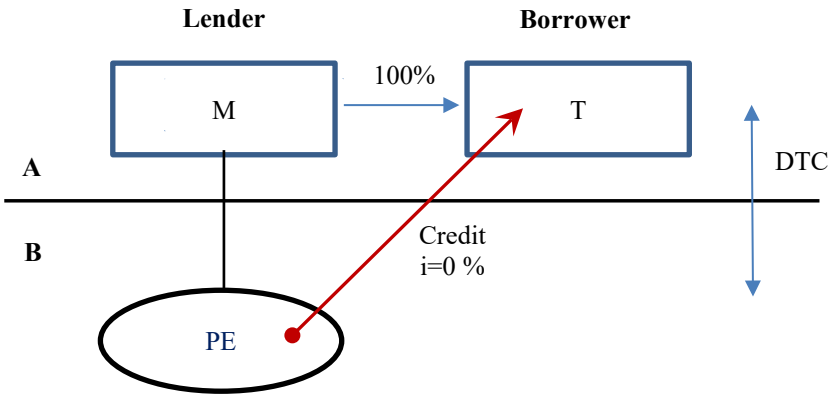

Figure 3: Application of Article 21 new version to the free transfer of use (interest) and taxation of deemed interest income in source state A

According to original DTC law (MTC 1977/2008/2014/2017), the deemed interest income of the lender M is not subject to the interest article under Article 11 (3) MTC. Consequently, the interest article does not apply and in particular not Article 11 (2) MTC. Rather, income within the meaning of Article 21 MTC (Other income) is given. However, according to Article 21 (2) MTC, Article 7 applies to the deemed interest income, since the loan claim and the deemed interest claim belong to the permanent establishment in State B. Accordingly, the deemed interest income is part of the business profits of M's permanent establishment in the other Contracting State B. Contracting State A is therefore not entitled under DTC/MTC law to deduct withholding tax on the deemed interest income. According to Article 23A MTC, the exemption method applies to the permanent establishment profits from B, so that Contracting State A can not tax the deemed interest income.

However, the situation is different taking the proposed new version of Article 21 DTC/MTC into account. Under Article 11 (3) MTC, the deemed interest income of the lender M does not constitute interest within the meaning of Article 11. Therefore, the interest article Article 11 MTC does not originally apply. Rather, Article 21 MTC is relevant for this income. According to Article 21 (2), sentences 1 and 2 MTC, Article 7 applies to the deemed interest income because the receivables belong to the permanent establishment in Contracting State B. Article 21 (2), sentence 3 does not apply (directly), since this provision only covers actual or original interest payments within the meaning of Article 11 (3) MTC. Consequently, Contracting State A can not levy a withholding tax on the deemed interest income. However, Article 21 (3) sentence 1 provides that source State A may tax the deemed interest income notwithstanding Article 21 (2) since it originates from its territory (debtor T is a resident of Contracting State A). Thus, according to Article 21 (3) sentence 2, the income is deemed to be interest income according to the domestic tax law of the source state A, so this provision rules the application of the interest article (Article 11) with the possibility of taxation at source according to Article 11 (2). However, the deemed interest income is attributable to the permanent establishment in Contracting State B for tax purposes. In these cases, Article 21 (3) sentence 4 stipulates that the provision of Article 21 (2) is to be applied accordingly to this deemed interest income within the meaning of Article 21 (3) sentence 2. Therefore, under these regulations, interest income now exists that falls under Article 21 (2) sentence 3, so that source state A can levy withholding tax on the deemed interest income in the corresponding application of Article 11 (2). The exemption of the profit of the permanent establishment in Contracting State A, which also includes the deemed interest income from Contracting State A, continues to apply. In the overall view, the interest-free loan with transfer pricing adjustment is taxed in the same way as an interest-bearing loan. There is no loss of taxation in the source state A. Compared to the current DTC law, Article 21 in the proposed new version leads to appropriate tax consequences.

7. CONCLUSION

The main findings obtained as a result of this study can be outlined as follows: The current DTC law has potential shortcomings concerning the appropriate taxation of the free transfer of use. This affects the granting of loans and licensing free of charge. According to the current treaty law (MTC 1977/2008/2014/2017), the state of residence of the borrower or licensees (here referred to as source state) can not tax deemed income from a free transfer of use against the grantor. This could be demonstrated within the study through examples and a comparative analysis. Nevertheless, in these cases, the source state is in principle obliged under treaty law to make a counter-adjustment at the level of the recipient of the free use under Article 9 (2) MTC. In the overall view, there is a systematic loss of taxation in the source state in the case of free transfers of use. The existing DTC law (Articles 9, 11, 12, 21) does not adequately cover these cases. Compared to a transfer of use for consideration, it leads to a distortion of the allocation of taxation rights between the Contracting States under treaty law. A possible solution for the further development of DTC law concerning an appropriate taxation of free transfers of use is a modification of Article 21 DTC/MTC (Other Income). Within the framework of this study, a new version of Article 21 had been elaborated and tested. This is a universal solution that principally covers all cases of free transfers of use. Compared to the existing DTC law, Article 21 in the new version proposed here leads to appropriate tax results in the case of free transfers of use, taking into account the source state and any transfer pricing adjustments. At the same time, the different treatment of the transfer of use for consideration and the free transfer of use under treaty law is eliminated, and appropriate taxation is achieved. This proposed solution is suitable for implementation in the next MTC as well as in bilateral DTCs. Therefore, this study contributes to the improvement of DTC law.

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