Tax residency new implications

Automatic exchange of information and transparency rules are changing the way resident taxation is applied

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The definition of who is considered 'resident' in terms of applying taxation is a matter of sovereignty. Countries usually extend or limit the scope of income taxation by adopting one of the three current worldwide tax systems: Territorial or residential or citizenship. Some have attempted to mitigate the advantages and limitations of each system by enacting hybrid systems, as in the U.K. and Lebanon.

TAXATION SYSTEMS EXPLAINED

The new global transparency rules mean residency tax issues are now more acute than they were previously. 'Residential' criterion is the most common and applied system for most countries (177) to calculate the taxable income. This system taxes residents on their worldwide (local and foreign) income and nonresidents only on their local income. The 'territorial' system taxes the sole locally generated income regardless of the residence or the citizenship of the taxpayer earning such income. The 'citizenship' taxation system is applied by only two countries: The United States and Eritrea. In this system, the country taxes the worldwide income of residents (whether citizens or not), as well as the worldwide income of all citizens, resident or nonresident.

TAX CONVENTIONS

Since conceptual differences can exist between tax systems adopted by each country, these differences most often lead to cases of double taxation or no taxation in international trade and bilateral transactions. For instance, double taxation problems may arise when a taxpayer who has a personal relationship with one country (the home country) derives income from sources within another country (the host country). The host country usually taxes the concerned person on the basis of that country's territorial criterion, whilst the home country may also tax the said person's income on the basis of residency and/or citizenship criterion. In order to prevent double taxation, bilateral tax treaties, according to the Organization for Economic Cooperation and Development (OECD) model, has been signed and adopted by several countries. When signed, treaties prevail over internal laws, they also tend to have 'tie breaker' clauses for resolving conflicts between residency rules. Moreover, and as a result of the OECD fight against tax havens, several countries have been compelled lately to sign or commit to a multilateral treaty (MCAA) for transparency and automatic exchange of information for tax purposes (Global Forum) which defines and applies a 'common reporting standard' (CRS). The aim of this new automatic standard is to expose the financial assets held in off-shore financial centers so that they may be subject to tax by home revenue authorities. Effective automatic exchange of information requires a common standard on the information to be reported by financial institutions and exchanged with residence jurisdictions. This is to ensure that the reporting is aligned with the interests of the residence country, which would limit the opportunities for taxpayers to hide income or assets.

SCOPE OF CONVENTIONS

Historically, initial OECD standards required exchange of income information 'on request'. The requested state was compelled to provide relevant information, but subject to safeguards on confidentiality and limitations on use of exchanged information. At a later stage, OECD members found that it may be more efficient to establish 'automatic exchange' relationships. This is why the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "Convention" or the "MAC") was amended. One of its main advantages is its multilateral side, and its global reach. Nevertheless, although the agreement would be multilateral, the exchange of information itself would be on a bilateral basis, between the two concerned countries.

LOCAL APPLICATION

Under the said Convention, the requested state is not allowed to invoke a lack of a domestic tax interest in the information, or bank secrecy, or other constraints as a bar to exchange of information. This is what has been sustained by Lebanon primarily by virtue of the Law 43 in November 2015. But this law comprised a prerequisite to access tax and bank information. It linked the requests to cases of 'obvious tax fraud', 'refutable presumptions' or 'final judgment.' The taxpayer had also the right of appeal prior to information exchange. This law was rejected by the Global Forum and found to be inconsistent with the standard. Lebanon was consequently forced to replace it with a new Law (No 55) dated October 2016, which modified the former procedure and endorsed both the Convention (MAC) and the Multilateral Competent Authority Agreements (MCAA). Prerequisites for income information exchange were not requested anymore. Still, the Global Forum cited a number of other deficiencies. These include mechanisms to identify beneficial ownership of bearer share companies and domiciliary companies, and the lack of legal authority to access bank information. To avoid the risk of being considered as non-compliant, Lebanon was forced to achieve an improved legal framework. It had to adopt, among other things, a reporting regime which limits the opportunities for taxpayers to interpose substitute legal entities, in order to hide income. This requires financial institutions to look through shell companies, trusts or similar arrangements, to cover situations whereby a taxpayer normally seeks to hide income. The improvement task was achieved through several laws adopted lately. The first abolished the bearer shares. The second imposed several obligations on the resident trustees of foreign trusts. The third amended the Code of Tax Procedure in order to enable the Lebanese Tax authorities to access the requested information and set forth a clear definition of the resident. As a result, Lebanon was deemed eligible to move to a Phase 2 Peer Review even though it has still to prove the effectiveness of the exchange of information upon request and to adopt additional regulations in order to implement the Common Reporting Standard. In order to activate 'automatic information exchange', Lebanon must reach separate agreement with each participating party. Actually, Lebanon and the said concerned participating party should agree on a reciprocal insertion on their respective lists of countries with which each of them wishes to exchange automatically. Lebanon must also file a notification about this with the OECD Secretariat. Consequently, the definition of residence turned out to be a cornerstone of the new fiscal globalization, with several connected implications.

HOW TO IDENTIFY A TAX RESIDENT

According to the OECD model, a 'resident' of a contracting state means "any person who under the law of that State is liable to tax by reason of their [effective] residence, head office or place of management (business), or any other criterion of a similar nature." When a taxpayer is considered a resident by two states under the laws of each state, the OECD treaty enumerates the alternative criteria to be implemented in the following order of priority: (i) Permanent home, (ii) Center of vital interests, meaning the state with which a person's personal and economic relations are closer, (iii) Habitual residence, (iv) Nationality. When none of these criteria is absolutely conclusive, the concerned person should supply documentary evidence to confirm his actual place of 'residency', and the concerned financial institution (FI) should make its research. In case of conflicting data, reporting would be done to all concerned countries for which indicia have been found. For any newly discovered indicia, or change in circumstances, the reporting FI must inform each jurisdiction for which such indicia is linked.

'RESIDENTS' IN LEBANON

Historically, the Lebanese tax system is based, in consideration of income taxes on professional revenues, on the territoriality principle which taxes only income derived in Lebanon whether by residents or non-residents. Profits realized on works and transactions conducted abroad are normally not subject to the Lebanese business income tax. The Lebanese Tax system however adopts the residential system for a few taxes, such as tax on movable capital gains or on income from movable assets. For instance, Income Tax Law considers as liable to the local tax income from interest, dividends, bonds, even if reverting from outside sources. The same applies for inheritance and gift taxes. The definition of residence was recently resettled by virtue of the law No 60 dated October 2016 which makes a distinction between the moral entities and natural persons. It considers that moral entities are deemed to be Lebanese residents if they fulfill one of the two criteria: (i) They are set up or registered in compliance with Lebanese laws, (ii) They maintain a place of business in Lebanon. Natural persons are considered Lebanese residents if they: (i) Have an office in Lebanon to undertake their activities, (ii) Have a permanent home constituting an habitual residence for them or their family, (iii) Spend in Lebanon more than 183 days (six months) within a twelve month period. The principle stating, for professional revenues, that 'in Lebanon the only taxable income is the one that has been generated in Lebanon' remains applicable - except for the income derived from foreign movable capital as was the case before, for which tax have to be paid in Lebanon. The issue at stake for the forthcoming period is to observe how those criterion of tax residence will match together, and to which extent each country will still enjoy a high level of fiscal sovereignty. Lebanon is one of those countries that despite its obligation to comply with international standards will remain largely free to design its tax system in a way that meets its objectives and requirements.

> Prerequisites for income information exchange are not requested anymore

ON OUR WEBSITE

More information is available by typing the numbers below into the **Reference Finder** on our home page

- **L0517-152** BDL Circular 138 about tax-related bank secrecy
- **L0517-153** Law about exchange of tax data

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