Michael Lang

Introduction to the Law of Double Taxation Conventions

Linde

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Preface

For many years now I have been holding lectures on the law of double taxation conventions. In the course of my teaching activities I have also developed relevant course materials. In 1997, these materials were compiled in a small book, which I first published in German. In 2002, the second edition of this book was released. From its conception, the book was aimed to provide both students and practitioners with the basic issues of the system and the application of double taxation conventions.

Originally published in German, the book now serves as a basis for this volume. It has been fundamentally edited and modified. Not only were the developments in international tax law that have occurred during the past 8 years incorporated but the contents of the book were also globalized: The book will be useful for all students and practitioners who are dealing with questions of double taxation conventions – irrespective of their national background. The book therefore does not consider one jurisdiction in particular but rather takes examples from a wide range of different countries and their jurisdictions. I hope that in this way it can be of help and use for students and practitioners from all around the world.

I would like to thank the entire team of the Institute for Austrian and International Tax Law that has considerably supported me over several months in the course of this project. Especially, the research and teaching associates Veronika Daurer and Oliver-Christoph Günther and the research associates Francesco Avella and Shauna Pitman have worked intensively towards the publication of this book. I would like to thank them with all my heart for their excellent engagement and efforts as well as for their numerous critical remarks which have substantially enriched the contents of the book. Moreover, I am grateful to the publishing houses Linde (Vienna) and IBFD (Amsterdam), who have taken over this publication project. I am happy about this cooperation, which will ensure that the book will be globally available.

Vienna, June 2010 *Michael Lang*

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List of abbreviations

AB	*Aktiebolaget* (Swedish public limited company)
AG	*Aktiengesellschaft* (Austrian/German public limited company)
AOA	Authorized OECD approach
ASA	*Archiv für Schweizerisches Abgabenrecht* (Swiss periodical)
AStG	*Außensteuergesetz* (German International Transaction Tax Act, contains inter alia the German CFC legislation)
AWD	*Außenwirtschaftsdienst des Betriebsberaters* (German periodical)
BAO	*Bundesabgabenordnung* (Austrian Federal Tax Code)
BB	*Der Betriebsberater* (German periodical)
BFH	*Bundesfinanzhof* (German Federal Tax Court)
BFIT	Bulletin for International Taxation (Dutch periodical)
BMF	*Bundesministerium für Finanzen* (German/Austrian Federal Ministry of Finance)
BNB	*Belissingen in Belastingzaken-Nederlandse Belastingsrechtspraak* (Netherlands Taxation Reports)
BStBl	*Bundessteuerblatt* (German Federal Tax law Gazette)
BTR	British Tax Review (British periodical)
BV	*Besloten Vennootschap* (Dutch limited liability company)
CGT	Capital gains tax
CP	Cost plus
CTC	Canadian Tax Cases
CUP	Comparable uncontrolled price
DB	*Der Betrieb* (German periodical)
DBA	*Doppelbesteuerungsabkommen* (German for double taxation convention)
DStZ	*Deutsche Steuerzeitung* (German periodical)
DTC(s)	Double taxation convention(s)
EC	European Community
EEC	European Economic Community
EFG	*Entscheidungen der Finanzgerichte* (collection of German court decisions)
ET	European Taxation (Dutch periodical)
EU	European Union
FJ	*Finanzjournal* (Austrian periodical)
FS	Festschrift
G-20	Group of Twenty
GAAR	General anti-avoidance rule
IBFD	International Bureau of Fiscal Documentation
IEHC	Irish High Court decisions

SEK	Swedish krona
IFOWS	International Food and Wine Shows (Indian trade fair)
Introd.	Introduction (in Vogel, DTC)
InvFG	*Investmentfondsgesetz* (Austrian law applicable to investment funds)
IRS	Internal Revenue Service (United States)
IStR	*Internationales Steuerrecht* (German periodical)
IT	Information technology
ITA	Income Tax Act
ITLR	International Tax Law Reports (UK periodical)
ITR	Indian Tax Reports
Ltd.	Limited liability company
MAP	Mutual agreement procedure
m.no.	Marginal number
NC	Nordic Convention
NV	*Naamloze Vennootschap* (Dutch public limited company)
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD Model Tax Convention on Income and on Capital[1]
OEEC	Organisation for European Economic Co-operation
OJ	Official Journal (European Community)
ÖStZ	*Österreichische Steuerzeitung* (Austrian periodical)
PE	Permanent establishment
RIW	*Recht der Internationalen Wirtschaft* (German periodical)
RP	Resale price
RStBl	*Reichssteuerblatt* (Tax gazette of the German Reich)
SA	*Société anonyme* (French public limited company)
STC	Simon's Tax Cases (UK)
StuW	*Steuer und Wirtschaft* (German periodical)
SWI	*Steuer und Wirtschaft International* (Austrian periodical)
TPGs	Transfer Pricing Guidelines (OECD)
TTCL	Tax Treaty Case Law (IBFD database)
UCITS	Undertakings for collective investment in transferable securities
UN Model	UN Model Tax Convention on Income and on Capital[2]
USD	US dollar
VAT	Value added tax
VCLT	Vienna Convention on the Law of Treaties

[1] All references to the OECD Model and the OECD Commentary are to the 2008/2010 version (unless otherwise indicated).

[2] All references to the UN Model and the UN Commentary are to the 2001 version (unless otherwise indicated).

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I. The problem of double taxation

1. Basics of international law

States can levy taxes by virtue of their sovereignty. Tax sovereignty, however, is not unlimited. Not all situations can be taxed. There must either be **a personal or an objective nexus**, or connection, **between the taxpayer and the state**. With respect to a personal connecting factor, it is sufficient that this exists with respect to the person concerned. Connecting factors for individuals frequently include domicile, residence or citizenship. For legal entities, the factors usually include the place of incorporation and the place of effective management. With regard to an objective connecting factor, it is sufficient that parts of the transaction or activity involve the taxing state or that the object of the action is somehow connected to the taxing state. **1**

In international law practice, there are no significant limits on the tax sovereignty of states. In designing the domestic personal tax law, the national legislator can even tax situations when, for example, only a "**genuine link**" exists. It is only when neither the person nor the transaction has any connection with the taxing state that tax cannot be levied. **2**

Example: *According to the Indian legal tax system, tax is levied when a "genuine link" exists. Pursuant to Sec. 9(1)(i) of the Income Tax Act, tax is levied on all income earned outside India which accrues, whether directly or indirectly, through or from any business connection in India. This principle formed the basis for the opinion of the Indian Authority for Advance Rulings (AAR) that a commission paid to a non-resident agent may be taxable in India even if the services are rendered outside India. Those services consisted of pursuing and soliciting the participation of foreign concerns, undertakings and government departments in the International Food and Wine Show (IFOWS) in India. Although the activity of the agent was carried on abroad, the AAR observed that the agent's right to receive commissions arose in India when the foreign concerns, undertakings and government departments participated in the IFOWS. Therefore, the AAR considered that the agent's income accrued from a business connection in India (cf. IN, AAR 3 Jul. 2006, Rajiv Malhotra, AAR/671/2005).* **3**

2. Circumstances giving rise to double taxation

2.1 Taxation of worldwide income (full tax liability) in two states

Since international law places few limits on the tax sovereignty of states, the same event may be taxed in two or more states. Under many domestic tax law systems, if there exists a close personal connection between the taxable person and the state, the person's worldwide income is taxed (**universality principle**). This is called full tax liability. However, if the connection is weak or consists **4**

only of objective factors, only the income earned in that state is taxed (**principle of territoriality**). This is called limited tax liability.

5 A taxable person can have close personal connections with two or more states. Under the tax laws of various states, for example, the person's domicile is a connecting factor. In others, residence and citizenship are connecting factors. Depending on the applicable laws, each of these criteria can lead to full tax liability. Therefore, it is not rare in practice, for the same person to be **subject to full tax liability in two or more states**. This can lead to the levying of taxes on worldwide income in two or more states.

6 ***Example****: An individual who lives in Spain and whose centre of economic interests is in France is subject to full tax liability in both states. If there were no DTC between France and Spain, both countries would tax the person's entire worldwide income.*

2.2 Full tax liability and limited tax liability

7 More frequently, persons are subject to full tax liability on the basis of their residence, citizenship, or any other criterion of a similar nature, in just one state and receive income from another state. In that other state, they are subject to limited tax liability. This limited tax liability applies only to the income earned in that other state. When the state of residence levies tax on worldwide income, the **income from the other state is taxed twice**. Thus, full tax liability in a state and limited tax liability in another can lead to double taxation.

8 ***Example:*** *A person resident and domiciled in the United Kingdom and subject to full tax liability therein holds shares in a Swiss corporation. The person does not have a home or domicile in Switzerland. The person receives dividends from the Swiss shares. These dividends are taxed in the United Kingdom since the person is subject to tax there on his worldwide income. In Switzerland, limited tax liability exists. Consequently, the dividends are also taxed in Switzerland.*

2.3 Limited tax liability in two states

9 Double taxation will not usually arise when a person is subject to limited tax liability in two states. Limited tax liability is based on the principle of territoriality. The two states will only levy tax on income arising in their respective territories. However, since the scope of the limited tax liability may not be the same in both states, double taxation may even arise **on the basis of limited tax liability**.

10 ***Example:*** *A person lives in Italy and is subject to full tax liability therein. The person receives income from shares of a corporation that has its legal seat in Germany and its place of effective management in Belgium. The dividends received from these shares are subject to limited tax liability in Germany and in Belgium. The income would be taxed a third time in Italy on the basis of the person's full tax liability if the DTCs did not provide a remedy.*

2.4 Economic double taxation

Thus far, the discussion has focused on double taxation arising from the taxation of the same person with respect to the same income in two or more states (juridical double taxation). However, it is also possible for the same income to be **taxed in the hands of different persons**. This situation is known as economic double taxation. **11**

Example: *The parent company of an unlimited company incorporated in the United Kingdom was a US corporation. The income of the UK unlimited company was taxable in the United Kingdom in the hands of the UK unlimited company itself. For US federal income tax purposes, the UK unlimited company was classified as a disregarded entity because it had a single shareholder, unlimited liability and had not made a "check-the-box" election. The income earned by the UK unlimited company was therefore considered to belong to the US parent corporation even if this income had not been distributed by the UK unlimited company. Thus the income of the UK unlimited company was taxable in the United Kingdom and in the United States in the hands of the US parent corporation (cf. UK, SCITD 19 Nov. 2008, Bayfine UK Products v. Revenue and Customs Commissioners).* **12**

The problem of economic double taxation frequently arises in cases in which **affiliated or associated corporations** that have their legal seats in different states enter into transactions with each other. Each residence state determines the taxable base for corporate income tax under its domestic corporate tax law. If the two companies enter into transactions with each other, the tax authorities of the two states could assign different values to those transactions (for a detailed description of transfer pricing issues, cf. m.no. 460 et seq.). Economic double taxation may then arise. **13**

Example: *A multinational group of companies has subsidiaries in China and Brazil. The Chinese company sells products to the Brazilian company for CNY 100,000. The Chinese tax authorities consider that the CNY 100,000 price is appropriate, whereas the Brazilian tax authorities are of the opinion that the appropriate price would be CNY 80,000. Income in the amount of CNY 100,000 is taxed in China, while the deduction in Brazil is limited to CNY 80,000.* **14**

3. Elimination of double taxation

3.1 Double taxation conventions

Cross-border economic relations would be considerably threatened if two or more states subjected the same income to taxation. Many states therefore enter into **bilateral international tax conventions** in order to eliminate double taxation. These agreements are called double taxation conventions (DTCs). They determine the extent to which each state may levy tax. **15**

16 The number of DTCs is constantly growing. At the present time, **more than 2,000 DTCs** exist. For example, the Netherlands is party to over 90 DTCs, while Switzerland is party to over 80 DTCs and the United Kingdom has concluded more than 115 DTCs.

3.2 Unilateral measures

17 Notwithstanding the extensive DTC network, not all cross-border relations are covered by DTCs. However, many states enact **unilateral measures** to prevent international double taxation in cases that are not covered by DTCs. Unilateral measures to prevent international double taxation differ from country to country. Essentially, three types can be distinguished: the exemption of foreign-source income, the tax credit for foreign taxes paid on foreign-source income and the deduction from the taxable base of foreign taxes paid on foreign-source income. The United States, for example, unilaterally grants a tax credit for foreign taxes paid on foreign-source income.

18 The above unilateral measures are granted under approaches that also **vary from country to country**. Generally speaking, two approaches can be distinguished: in some countries (e.g. Germany), precise rules are set out in the law; in other countries (e.g. Austria), much leeway is left to the tax authorities. Unilateral relief from international double taxation is sometimes granted subject to reciprocity (e.g. Brazil).

19 In some countries, the unilateral measures' provisions only apply when a **DTC is not applicable**, either because no DTC is in place with the country where the income is derived or because the personal (cf. m.no. 181 et seq.) or the substantive scope (cf. m.no. 222 et seq.) of the DTC is not fulfilled. In others, the unilateral measures' provisions also establish the details for the concrete **application of the methods** to relieve international double taxation provided for by DTCs. In the latter countries, therefore, the criteria set forth by the unilateral measures' provisions apply to determine the relief to be granted to a taxpayer under the applicable DTC.

20 ***Example:*** *In 2005, an Italian resident company carried on its activity in Romania through a permanent establishment (hereafter, PE). A DTC between Italy and Romania was in force in that year. The company asked the Italian tax authorities (Agenzia delle Entrate) to rule on whether the tax credit for taxes paid in Romania provided for by the applicable DTC was to be determined according to the criteria set out in the DTC or according to the criteria set forth by the unilateral measures' provisions contained in Italian tax law. The Italian tax authorities stated that the DTC only sets out a general obligation that Italy grants a tax credit for taxes paid in Romania on income that may be taxed therein. The DTC does not provide the details for the concrete application of such tax credit; these are established by domestic tax law. Therefore, the tax credit for taxes paid in Romania were to be determined according to the criteria provided by the unilateral measures' provisions contained in Italian tax law (cf. IT, AE 1 Jun. 2005, Risoluzione N.69/E).*

II. State practice in the conclusion of DTCs

1. Conventions in international law

At the conclusion of a DTC, the two parties to the convention accept an **international law obligation**. They commit themselves to relinquishing, completely or partially, the imposition of taxes in specific situations. The convention is subject to the rules of public international law. **21**

The contracting states are free to decide the manner in which they will give up taxing rights. For example, they may change domestic law so that only the transactions set out in the DTC regarding the imposition of taxes remain. Often, however, the conventions are **directly applicable** as domestic law. In this case, the DTC rules override the otherwise applicable domestic tax rules. **22**

2. The importance of model conventions

Every DTC is negotiated separately. Nevertheless, many of the existing DTCs throughout the world resemble each other. This can be traced to the model tax conventions developed by international organizations. These **model tax conventions** usually form the foundation for bilateral negotiations. The parties to the convention need only negotiate those points upon which they wish to deviate from the model tax convention. **23**

The **work of the League of Nations** contributed to the development of standardized model tax conventions. In the years between World Wars I and II the League of Nations produced several model tax conventions which gained importance in the negotiations of bilateral tax conventions between states and left their mark on the later work of other international organizations. **24**

The OEEC, and later the **OECD**, continued the work of the League of Nations. In 1963, 1977 and 1992, the OECD published model tax conventions in the area of taxes on income and on capital (cf. m.no. 30 et seq.). These agreements were further developed in 1994, 1995, 1997, 2000, 2002, 2005 and 2008. In 1966 and in 1982, model tax conventions in the area of inheritance taxes were published (cf. m.no. 531 et seq.). **25**

As an alternative to the OECD Model, a model tax convention was developed by the **Andean Group**. This model takes the special interests of developing countries into account. The source principle is of primary importance under this agreement. **26**

The United Nations published an independent UN Model in 1980; a revised and updated version was subsequently published in 2001. The next update is expected for 2011. This model is also based on the interests of developing countries. In most respects, the **UN Model** follows the OECD Model and deviations exist only with respect to certain issues. Major differences can be found in Art. 5 (permanent establishment), Art. 7 (business profits), Art. 9 (associated enterprises), **27**

Art. 10 (dividends), Art. 11 (interest), Art. 12 (royalties), Art. 13 (capital gains) and Art. 21 (other income).

28 ***Example:*** *The OECD Model provides that royalties are taxed exclusively in the state of the recipient's residence, to the exclusion of the source state (Art. 12 OECD Model, cf. m.no. 300 et seq.). According to the UN Model, royalties may also be taxed in the state in which they arise. The UN Model does not establish a tax rate for the source state but leaves this question open. The rate is to be established in bilateral negotiations. The UN Model's principle regarding source taxation for royalties considers the situation of the developing countries: know-how is provided primarily by entrepreneurs of developed countries to enterprises in developing countries. Only rarely does the opposite occur. Thus, developing countries want to retain the right to tax remuneration paid in return for know-how.*

3. The importance of the OECD Model

29 The OECD Models have had considerable influence in international tax law. They influenced other model tax conventions and many states use the OECD Model as a basis for their **DTC negotiations**.

30 In the area of taxes on income and on capital, the first model tax convention was submitted by the OECD Committee on Fiscal Affairs in **1963**. The OECD Model was published along with a Commentary that was also developed by the Committee on Fiscal Affairs. The Model and the Commentary were made the subject of a recommendation of the OECD Council to the Member States. The Council recommended that Member States continue their efforts to enter into bilateral tax conventions, that they adopt the OECD Model as a basis for their negotiations and that they continue to notify the Committee on Fiscal Affairs of their reservations on articles and observations on the Commentary.

31 In **1977**, a revised OECD Model was published by the OECD Committee on Fiscal Affairs. This revision took practical experience with negotiating DTCs into account. In particular, the Commentary was considerably amended and expanded.

32 In **1992**, the OECD Model was again revised. The OECD Committee on Fiscal Affairs decided to publish the OECD Model in a loose-leaf version, the idea being that in future, the agreement would be subject to continuous revision. Amendments followed in **1994, 1995, 1997, 2000, 2002, 2005 and 2008**. The next amendment will be published in September 2010.

33 The 1963 OECD Model was explained in the accompanying **Commentary** written by the OECD Committee on Fiscal Affairs. The Commentary was amended and considerably expanded in 1977 and 1992, and later on. "Reports" that had been published by the OECD Committee on Fiscal Affairs concerning numerous questions were included in the Commentary. In practice, the importance of the Commentary increased (cf. m.no. 85 et seq.).

4. Bilateral peculiarities

States that use the OECD Model as a basis for negotiations usually deviate from the model on some points. This is because most states cannot agree with all the rules of the OECD Model. Many OECD Member countries have entered reservations on specific rules of the OECD Model. The contracting states make allowances for their **own economic interests** as well as for the **peculiarities of their law and social systems**. **34**

> ***Example:*** *In the OECD Model, the PE concept is used to determine the right of a contracting state to tax the profits of an enterprise of the other contracting state. The DTC between Austria and the former Soviet Union (concluded in 1981, terminated in 2003) did not use the PE concept but instead used "representative agency". This different wording did not, however, mean that a different meaning was intended. The issue was that the Soviet negotiating team had considerable misgivings at that time that a foreigner could settle in the Soviet Union "permanently". Thus a different terminology had to be used (cf. Philipp, ÖStZ 1986, 216 et seq.). The current DTC between Russia and Austria contains the PE concept.* **35**

Numerous states also use the OECD Model as a basis for their **own model tax conventions** and incorporate their own deviations. They use these deviating models during their bilateral negotiations. **36**

> ***Example:*** *The United States is concerned about the improper use of a DTC. In order to prevent abuse, the United States attaches great importance to restrictions on the entitlement to the benefits of the DTC. Given this concern as well as other issues, the United States published its own Model Tax Convention in 1996 and issued a new version of this model in 2006. The United States uses this model in its bilateral negotiations. Thus, many DTCs concluded by the United States in recent years contain many similarities (cf. Avi-Yonah/Tittle, BFIT 2007, 224).* **37**

Model tax conventions are also published by countries that generally agree with the OECD Model standards but want to make clear the policy principles followed by their own treaty negotiators. For example, in 2007, Belgium published its own Draft Standard Model Convention and related Protocol although, at that time, it had made only seven reservations on the OECD Model and two observations on the Commentary. The **Belgian Model** officially sets forth the policy principles that the Belgian negotiators will follow in negotiating tax treaties and is presented as such to countries that want to enter into treaty negotiations with Belgium (cf. De Broe, *BFIT* 2008, 322 et seq.). **38**

III. The effects of DTCs

1. The allocation of taxing rights

In DTCs the two contracting states commit themselves to relinquishing or restricting their taxing rights. This should result in the elimination of double taxation. According to the DTC rules, certain income or capital can be taxed only in one of the two contracting states (**exemption method**, cf. m.no. 413 et seq.). Other income or capital can be taxed by both states proportionately: the right to tax for the source state is usually limited to a certain percentage, and the state of residence will give credit for taxes paid in the source state (**credit method**, cf. m.no. 432 et seq.). **39**

Example: *Under Art. 12(1) OECD Model, royalties can only be taxed in the state of residence. The source state is precluded from taxing. Dividends can, however, be taxed by the source state (Art. 10(2) OECD Model). Depending on the percentage of participation and the beneficial owner, the source state may tax dividends at 5 or 15% of the gross amount. The state of residence will also tax but will credit the taxes paid in the source state.* **40**

In tax literature, it is frequently said that DTCs **allocate jurisdiction to tax**. This terminology has been criticized (cf. Vogel, *DTC* Introd., m.no. 45b). States have original jurisdiction to tax and this is in accordance with international law. If this premise is accepted, it does not make any difference, in my view, whether the effects of a DTC are described as division, allocation or distribution of taxing rights, or whether one prefers, instead of the term "taxing rights", one of the following terms: tax sources, tax claims or taxable objects. **41**

In DTCs the contracting states bind themselves not to raise any taxes with respect to taxing rights that are given to the other contracting state under the tax convention. The DTC rule applies even if one of the contracting states to which the right has been given does not impose taxes. In this respect, the application of the DTC can lead to **double non-taxation**. **42**

Example: *An individual entrepreneur resident in Munich does not have a PE in Austria; however, many of its business assets are in Austria. The individual sells those assets long after their acquisition and realizes a gain. Under German tax law, the individual would be liable to tax in Germany. Under the DTC, however, Germany is bound to exempt this gain from tax. Austria may tax such profits under the DTC but is limited by its domestic law to taxing within the speculation period. Under Austrian domestic law, therefore, the gain on the sale is exempt from tax. As a result, the gain from the sale is taxed neither in Germany nor in Austria.* **43**

2. The limiting effects of DTCs

In DTCs the contracting states mutually agree to limit their taxing rights. Thus, DTCs affect the legal systems of both contracting states. In both states, domestic tax law is **restricted**. **44**

45 Vogel compares the way how a DTC applies to a "**stencil**" (cf. Vogel, *DTC* Introd., m.no. 56): the treaty acts like a stencil that is placed over the pattern of domestic law and covers over certain parts. In some areas, the pattern covers the domestic tax liabilities. In these cases, the imposition of taxes is restricted or eliminated. In the areas in which the pattern has holes, the domestic tax liability remains.

46 In tax literature, it has been said that DTCs **cannot generate tax liability**; however, there is no legal basis for this statement. There is no international law rule preventing tax liabilities from being increased because of a DTC. In practice, however, DTCs serve as a limitation on tax liabilities. This does not mean though that the application of a DTC could not worsen the position of the taxable person.

47 ***Example:*** *Revenues that are excluded on the basis of a DTC from the imposition of taxes in Austria are, according to a rulings opinion, not liable to tax in the sense of Sec. 20(2) Income Tax Act. Expenses connected to the exempt income are therefore not deductible (cf. also m.no. 421). Insofar as expenses are related to exempt income, a person's tax situation is worsened because, without the DTC, the expenses would have been deductible. Since the DTC rules are to be applied ex officio, in such a case, the taxable person must accept the DTC provisions.*

48 From the limiting effects of DTCs it can be understood that the exemptions granted by DTCs only affect positive earnings. DTCs would not, therefore, prevent foreign-source **losses** from offsetting the taxpayer's taxable base in the residence state. This conclusion has been drawn by the courts of several countries (e.g. Austria, Belgium, Finland, the Netherlands and Switzerland). According to the courts of other countries (e.g. Germany), however, DTCs have effects on positive and negative earnings. Thus, the DTC would prevent foreign-source losses from being taken into account in determining the taxpayer's taxable base in the residence state (for a comparative summary, cf. Vogel, *DBA* Art. 23, m.no. 45 et seq.).

3. The relationship to domestic law

3.1 Implementation of DTCs into domestic law

49 DTCs are treaties under international public law. It is up to the contracting states to decide how they are implemented into domestic law. Usually, this is a **constitutional issue**. According to constitutional provisions, DTCs might either have the same status as domestic provisions or they are superior to domestic provisions or their status might be below domestic provisions.

50 The contracting states oblige themselves to **implement the substance** of the provisions of a DTC. It is up to them whether they prefer to have the DTCs as such applicable or whether they introduce domestic provisions for that purpose.

3.2 Priority of DTC law

51 Irrespective of their status in domestic law, the content of the rules of a DTC often contradicts with domestic rules. According to most scholars, DTC rules are **special rules** in relation to domestic tax rules. The priority of DTC law is based on its *lex specialis* character.

52 ***Example:*** *A construction company resident in Bangladesh is hired to build an office in India and requires 4 months for the construction. Under the Bangladesh–India DTC, the income from this project cannot be taxed by India; Art. 7 of the DTC provides that income of a company resident in Bangladesh can only be taxed in Bangladesh. An exception exists if the Bangladesh company carries on business in India through a PE (Art. 7(1) of the Bangladesh–India DTC). Under Art. 5(2), however, a construction site constitutes a PE only if it lasts for more than 183 days. Therefore, there is no PE in India under the DTC. In India, income received in India or arising in India is taxable under Sec. 4 and Sec. 5 of the Indian ITA. Since the DTC is the more specific law, India will apply the DTC and not the domestic rules. The imposition of tax by India would constitute an infringement of international law.*

53 The characterization of DTC rules as special rules requires that DTC rules refer not only to the same requirements to which domestic tax rules refer but also to at least one supplementary requirement. Accordingly, DTC rules are as a rule only important if all the requirements for the application of a certain domestic tax provision are met and the DTC rules lead to different legal consequences. In other words, there are **two groups of requirements** in connection with DTC rules: One group consists of the requirements which lead to taxation under domestic law and the other group consists of the supplementary requirements that are found in DTC rules.

54 ***Example:*** *A scientist is resident in Switzerland and is subject to full tax liability therein. He performs independent personal services in Italy. Under Italian law, the scientist would be subject to tax on the income earned from these activities. Under Art. 14 of the Italy–Switzerland DTC (Art. 14 of the former OECD Model), however, as long as the scientist does not have a fixed base regularly available to him in Italy, Italy may not tax the income. The law in Italy (imposition of tax) is in conflict with the DTC (no imposition of tax). The conflict is to be resolved in favour of the DTC rule.*

55 In addition to the lex specialis rule, the ***lex posterior* rule** can play a role in the interpretation of DTCs. It is doubtful whether a domestic tax rule can prevail over an existing DTC. In these cases it is questionable whether the treaty prevails as lex specialis or whether a later domestic law prevails as lex posterior. This question cannot be decided by examining the provisions alone. In the scope of the interpretation, all the interpretation materials must be taken into account. If the interpretation leads to the result that the domestic law prevails, this constitutes an infringement of international law.

3.3 Priority of domestic law

56 If an interpretative provision specifies that the later domestic law derogates from the special rule provided by the DTC, the result must be regarded as a "**treaty override**". To the extent that a national legal system does not provide any constitutional law protection against international law violations by the legislator, however, a "treaty override" can only be countered at the international law level.

57 ***Example:*** *Individuals resident in Germany were partners in a limited partnership in Belgium. Under the Belgium–Germany DTC, the income earned by the individuals was exempt from tax in Germany because the exemption method applies to exempt income derived from the capital invested in a Belgian limited partnership. Instead, however, the individuals were subject to tax in Germany and were given a credit for tax paid to Belgium. German domestic law (the Außensteuergesetz) provided that when income derived from the capital invested in a foreign partnership is subject to a tax on profits of less than 30% in the source state, the credit method applies rather than the exemption method. The domestic law provision was introduced after the entry into force of the Belgium–Germany DTC and constitutes a treaty override (cf. GE, FG Münster 5 Jul. 2005, 15 K 1114/99, Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt).*

3.4 What to consider first in practice: DTC or domestic law?

58 In practice, the question of the relationship between domestic law and treaty law arises when cross-border situations have to be analysed. In determining whether the contracting state has any taxing rights, what should be **examined first**: domestic law or DTC? Should domestic law establish tax claims first or should the DTC be tested first to determine whether there is any right to tax under the DTC? This issue was extensively discussed in Germany (cf. Debatin, *DB* 1985 Beilage 23, 5 et seq.; Vogel, *DB* 1986, 508 et seq.; Debatin, *DB* 1986, 512 et seq.). The discussion has since ceased.

59 Vogel concisely summarizes the results of the discussion (Vogel, *DTC* Introd., m.no. 56; emphasis added): "Only very little legal background is required to recognize that logically, **both methods of procedure are equivalent**. Indeed, the treaty is lex specialis in relation to domestic law. The requirements for application of the allocation rules are, as discussed above, additional requirements for establishing tax liability, aside from those of domestic law. Illustratively expressed: the treaty acts like a stencil that is placed over the pattern of domestic law and covers certain parts. Whether the stencil or the pattern is examined first, the same conclusion results, so the order of application can be decided pragmatically from case to case." The order is therefore not a matter of interpretation and does not have any impact on the content of individual treaty articles. Anyone applying the treaty must consider this issue in every particular case exclusively under practical criteria.

60 ***Example:*** *In IN, ITAT 30 Jun. 2008, Epcos AG v. Assistant Commissioner of Income Tax, a German company earned income from the provision of technical services to an Indian subsidiary. The German company paid taxes in India at a rate of 10%, relying on the applicability of Art. 12 of the Germany–India DTC ("Royalties and fees for technical services"). The Indian Tax Officers assessed the German company arguing that Art. 7 rather than Art. 12 of this treaty was applicable. The Indian Tax Officers argued that the German company had a PE in India and therefore the income in question should be taxed in India in accordance with Art. 7 of the Germany–India DTC. They therefore assessed tax at 20% instead of 10%. The Indian Tax Officers gave an interpretation of Indian domestic law by which the onus of proving the non-existence of a PE in India was upon the German company, supporting their argument by stating that domestic law is to be applied first and tax treaty law is to be applied thereafter. The ITAT stated that there is no "conceptual support or other material whatsoever for 'domestic law first' approach, though, in all fairness, there is literature to support the proposition that the debate regarding whether one should see the treaty first or domestic law first is a non-starter. Whichever path we follow, we reach the same destination anyway; whether or not cross-border income is taxable in the source state in the light of the domestic tax laws read with the applicable tax treaty, it would not make any difference, in the ultimate analysis, whether one examines the case on the touchstone of the scheme of the treaty first and domestic law later, or vice versa."*

61 What has proven to be **useful** is the practice of first consulting domestic law to determine whether any liability for tax exists and then consulting the DTC to determine whether it provides any relief from this liability. If there is no liability for tax under domestic law, there is no need to consult the DTC since the DTC in practice does not create a liability to tax (cf. m.no. 46). The mere allocation of taxing rights to a contracting state does not create an independent basis for taxation. On the other hand, it can occasionally be useful to consult the DTC first to determine whether a contracting state has the right to tax at all, and, as a second step, to determine the manner in which the contracting state exercises this right. If, under the treaty, there is no right to tax, there is no need to consult domestic law.

62 ***Example:*** *A resident of Canada wins a lottery in Austria. One begins with the domestic right to tax. Since Canadian domestic law does not tax lottery winnings, the winnings are not taxable in Canada. From the point of view of Canadian tax law, an examination of the DTC between Austria and Canada is therefore unnecessary. This is not altered by the fact that under Art. 21(1) of the DTC between Canada and Austria, Canada has the right to tax this income. Furthermore, the lottery winnings are not taxable in Austria either because they are not regarded as taxable income. This is not altered by the fact that under Art. 21(2) Austria–Canada DTC, Austria also has a right to tax this income. The DTC does not provide an independent legal basis for taxing this income.*

63 H. Loukota (*SWI* 1998, 560; cf. also Lang, *SWI* 1999, 62 et seq.) is in favour of the "**three-step-method**". Step one is to first examine domestic law to determine whether any tax liability exists. Step two is to decide, on the basis of the DTC, whether and to what extent the domestic taxing right can be maintained. In step three, the taxing right that is in line with the application of domestic law (step 1) and in conformity with the DTC (step 2), is enforced under domestic law. This is a practical recommendation on how to proceed by H. Loukota. In the present writer's opinion, it is questionable whether the relationship between domestic law and treaty law is not unnecessarily complicated when steps 1 and 3 are separated when domestic law is enforced. If one refrains from this question, the suggestion by H. Loukota leads to the following procedure: domestic law should first be applied and then attention should be paid to treaty law. This can be useful in some but not in all cases. As H. Loukota further points out in another article (*SWI* 2001, 467 note 2), one can not object to the above "three-step-method" if one is aware of the fact that it is equivalent, in the end, to starting with domestic law or treaty law when dealing with a cross-border situation.

IV. The interpretation of double taxation conventions

1. Principles of interpretation in international law

64 The interpretation of DTCs follows the principles of international law. These principles are codified in Art. 31 et seq. of the **Vienna Convention on the Law of Treaties** (VCLT). The VCLT itself is an international convention. According to international law doctrine, it also applies to agreements concluded before its ratification (cf. Vogel/Prokisch, in IFA (ed.), *Interpretation*, 66).

65 Pursuant to **Art. 31**(1) VCLT, a treaty must be interpreted in good faith with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. For the purpose of the interpretation of a treaty, Art. 31(2) VCLT provides that the context includes, "in addition to the text, including its preambles and annexes", any agreement made between the parties in connection with the treaty as well as any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. Art. 31(3) VCLT requires that together with the context, there shall be taken into account "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions", "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation", and "any relevant rules of international law applicable in the relations between the parties". A special meaning is to be given to a term, pursuant to Art. 31(4) VCLT, "if it is established that the parties so intended". Recourse may be had to supplementary means of interpretation, according to Art. 32 VCLT, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Art. 31 VCLT, or when the application of Art. 31 VCLT leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable.

66 International law rules of interpretation do not significantly differ from those of domestic law. There are no particular methodologies for special fields of law. Thus in international law, one also uses **the grammatical, the systematic, the teleological and the historical interpretation methods**. With the help of all interpretation methods, the meaning of DTC rules is to be derived exclusively from the convention. One interpretation method does not prevail over another. Which argument is most convincing must be decided on a case-by-case basis.

67 It is sometimes argued that Art. 31(3)(a) VCLT provides grounds for peculiarities in the interpretation of international law. **Art. 31(3)(a)** VCLT provides that "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions" shall be taken into account when interpreting a convention. In my opinion, however, this rule does not provide grounds for peculiarities in the interpretation of international law. Art. 31(3)(a) VCLT cannot be interpreted as an unlimited authorization for the development of

the law by tax authorities, because the VCLT allows an amendment to the convention only when both contracting states agree. This, however, is regarded as a change in the DTC and consequently in many countries it requires authorization by parliament. This suggests that it is not possible for administrative bodies to change DTCs by way of a new interpretation. In addition, when distinguishing between the interpretation of conventions and amendments to conventions, one must differentiate between different types of international law conventions. In principle, there is a difference between conventions which are only binding on states and those that, once implemented, give rise to rights for persons. Provided that the legal systems of the contracting states are founded upon the rule of law, it is difficult to argue that conventions that create rights for persons are capable of further dynamic development. In particular, the purpose of DTCs is to restrict existing tax claims. They cannot, therefore, be interpreted in a way that will modify this restriction. According to this view, therefore, tax authorities have no leeway for developing the law in a way that would add to or change the meaning of a provision of a DTC. In the interpretation of a convention, one must assume that the negotiators did not intend to violate basic constitutional principles of the legal systems of the two contracting states. Tax authorities have no greater leeway, in the interpretation of a DTC, to develop the law through later agreement than they do in the interpretation of domestic law. Therefore, the interpretation principles contained in Art. 31(3)(a) VCLT do not deviate from the principles of interpretation of domestic law.

68 ***Example:*** *The taxpayer was a resident of France and worked in Germany for a German company. Under the France–Germany DTC, if the taxpayer is a frontier worker, he will be exempt from tax in Germany. Under Art. 13(5) (Income from employment) of the DTC, the frontier worker must generally return home every day in order for the state of residence to have the right to impose income tax. The French and German tax authorities had agreed, in a mutual agreement procedure pursuant to Art. 25(3) (Mutual agreement procedure) of the DTC, that a taxpayer would not lose his status as a frontier worker if he did not return home the same day or worked outside the border zone on 45 or fewer days in a full calendar year. This mutual agreement had been duly published. In the tax years under review, on a considerable number of days, the taxpayer did not return home the same day, or worked in Germany outside the border zone, or in third countries. The taxpayer relied on the mutual agreement and claimed an exemption from income tax in Germany. The German Federal Tax Court (BFH), however, ruled that Art. 13(5) of the DTC requires a frontier worker to return home every day. Consequently, the status of frontier worker is lost if the employee does not return home on one or more nights for reasons related to the exercise of the employment. The mutual agreement between the competent authorities could not alter the provisions of domestic law after the incorporation of the treaty in domestic law.*

Therefore, the taxpayer could not rely on the mutual agreement (GE, BFH 10 Dec. 2001, I B 94/01; cf. also GE, BFH 11 Nov. 2009, I R 84/08).

69 The same considerations apply with respect to **Art. 31(3)(b)** VCLT. According to this rule, "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" is to be taken into account in the interpretation. The "agreement" referred to in Art. 31(3) VCLT is not the one existing at the conclusion of the DTC. According to prevailing opinion, a new understanding of the convention can be taken into account – provided it has found its way into later practice. Consequently, later administrative practice between the two contracting states can have an impact on the interpretation of the DTC. However, this does not confer an unlimited right for the development of the law by administrative interpretation. International law acknowledges that the interpretation of the convention by means of later practice is limited. With tax conventions that create rights for persons, the interpretation of the convention through subsequent practice of the administrative authorities can only be of **minor importance**. An accurate interpretation of Art. 31(3)(b) VCLT is therefore that the development of the law through subsequent practice of the administrative authorities of the two contracting states is as limited as it is in the interpretation of domestic law.

70 ***Example:*** *An individual resident in Germany is authorized signatory (Prokurist) of a Swiss company. For this purpose he sometimes works in Switzerland but most of the time in Germany. Under Art. 15(4) of the Germany–Switzerland DTC, the income derived from his function may be taxed in Switzerland – where the company is resident. Double taxation is avoided by the exemption method, "provided the employment is exercised in Switzerland" (Art. 24(1)(1)(d) of the Germany–Switzerland DTC). Otherwise the credit method would apply. In a recent case, the German Federal Tax Court had to interpret the term "exercised in Switzerland" and for this purpose the court referred to how the provision had been interpreted since it first came into effect. It was argued that already in earlier tax treaties concluded by the countries the treaty partners considered the activity of an authorized signatory as being exercised where the company was resident. This view has not been changed in subsequent conventions or protocols and has been confirmed in prevailing case law. Even though the wording of the provision could lead to a different understanding, the court held that subsequent practice in the meaning of Art. 31(3)(b) VCLT is an even stronger indication as to how the provision has to be interpreted (cf. GE, BFH 25 Oct. 2006, I R 81/04).*

2. The use of principles of interpretation stemming from international law with respect to DTCs

2.1 Autonomy of DTC law

71 DTCs, as international law conventions, have an impact not only on the domestic tax law of one contracting state but also on the laws of at least two states. DTC

provisions aim to shape the legal order of the contracting states in a way that the respective taxing rights are assigned to one of the contracting states or to both contracting states proportionately. In order to guarantee an exact meaning, the DTC must therefore be viewed separately from domestic legal systems and the meaning of the DTC provision must be determined without reference to any domestic law. Accordingly, **DTC law** must be regarded as **autonomous** with respect to domestic law. Domestic law and treaty law can only be interpreted within their own contexts.

72 ***Example:*** *In many countries, domestic law contains a definition of "permanent establishment". When a DTC patterned after the OECD Model uses the term "permanent establishment", it cannot be understood in terms of the domestic law but rather in accordance with the DTC. In DTCs that follow the OECD Model, Art. 5 contains an autonomous definition of "permanent establishment". This definition is to be used for the interpretation of the concept in the DTC.*

73 In interpreting a DTC "within its own context", it is necessary to determine the objectives of the respective DTC provisions and to take them into account. The overall goal of DTCs is the **avoidance of double taxation**. However, the interpretation of the DTC provisions should not be based on this general purpose because DTCs do not avoid all cases of double taxation but only those within their scope. If, for example, a person is subject to limited tax liability in both contracting states, double taxation may remain despite a DTC (cf. m.no. 181). The same is true for cases in which a tax or a duty is not covered by Art. 2 of DTCs patterned after the OECD Model ("taxes covered") (cf. m.no. 222 et seq.). Nor can cases of double taxation, pursuant to which income is assigned to different taxable persons in the two contracting states, be typically resolved by means of a DTC (cf. m.no. 411). Since DTCs only avoid double taxation under the conditions established therein, the purpose of the avoidance of double taxation is of no assistance if the question is whether, in a certain situation, these conditions are met. The situation is similar in domestic law when it comes to the general objective of taxation, which is to raise revenues for the state. In determining whether a certain situation is covered by domestic law, there is no point in taking this objective into account. Thus, the proposition that the purpose of a DTC is the avoidance of double taxation does not help in resolving individual DTC questions. Furthermore, in DTC law, it is not enough to refer to general principles. The object and purpose of every single provision needs to be understood.

74 Since the purpose of DTCs is the avoidance of double taxation, it is occasionally concluded that the purpose of DTCs also includes **the avoidance of double non-taxation**. In my view, however, this is incorrect in such general terms (apparently also Vogel, *IStR* 2002, 93). When the exemption method is adopted in the DTC (in detail cf. m.no. 413 et seq.) the latter purpose may be assumed only if it is combined with a "subject-to-tax clause" (cf. m.no. 417). In this case, taxation

is secured in at least one of the two states and double non-taxation is thereby avoided. Double non-taxation can otherwise be a legitimate result of the interpretation of the treaty if, for example, one of the two states may not tax due to the provisions of the treaty and the other state cannot exercise its taxing rights because there is no domestic legal right to tax. The principle of avoidance of double non-taxation is therefore not sustainable as a principle of general interpretation (differently Zorn, *SWI* 2001, 461).

75 ***Example:*** *An individual resident in the United Arab Emirates held shares in a private Indian corporation, which she sold in 2000. The former Art. 13(3) India–United Arab Emirates DTC stated that capital gains on the alienation of shares are taxable only in the contracting state of which the alienator is resident. Under the domestic tax law of the United Arab Emirates the capital gain is tax free. The Indian court decided that entering into a tax treaty which may leave scope for double non-taxation is a conscious decision of the respective contracting state, but once such a tax treaty, as may leave scope for double non-taxation, is entered into, judicial forums have to interpret the provisions of the tax treaty as they exist. The capital gain of the individual resident in the United Arab Emirates was therefore neither taxed in the residence state nor in India (IN, ITA 29 Oct. 2009, No. 1876/Mum/2006, Meera Bhatia v. ITO).*

2.2 The importance of domestic law

76 Domestic law is taken into account for the interpretation of a DTC when **nothing more can be derived from the treaty itself**. One must first, however, try to find a solution in the DTC by means of all methodological possibilities. All systematic, teleological and historical aspects must be considered. It is extremely rare that a solution cannot be found by taking these aspects into account.

77 ***Example:*** *The OECD Model and the DTCs patterned after it contain the term "business profits" (Art. 7 OECD Model). The concept of business (or enterprise), however, is not defined in the convention itself. This cannot automatically lead to the conclusion that for the interpretation of the concept, domestic law and domestic terminology apply. The system should instead take the systematic, teleological and historical factors of the DTC into account. This kind of interpretation, in my opinion, leads to the result that Art. 7 of the OECD Model applies to income from activities that are not services or where there is significant capital expenditure (cf. Vogel, DTC Art. 7, m.no. 22). Under this systematic approach, when the income of an IT consultant is to be categorized under Art. 7 or under another allocation rule such as Art. 14 of the former OECD Model, one needs to consider whether the capital expenditure is merely ancillary. Since the activity of an IT consultant is a service, this would go against categorizing the income under Art. 7 OECD Model. The application of Art. 7 OECD Model can therefore only depend on*

the volume of capital expenditure in this case. The income of an IT consultant who has significant expenses (e.g. acquisition of hardware or purchase of programs) could fall under Art. 7 OECD Model, while the income of another IT consultant who has no significant capital expenditures can fall under Art. 14 of the former OECD Model. This interpretation, which is exclusively obtained from the treaty, makes it possible to attribute the income to the same allocation rule in both states. If, however, one state rejects this interpretation and instead consults the respective domestic law provisions, the outcome can be that the income falls under Art. 7 OECD Model in one state and under another allocation rule in the other state. Double taxation or double non-taxation can therefore arise.

78 In certain cases, however, the autonomous interpretation of the DTC rules indicates that **domestic law** needs to be taken into account. In addition to their international law character, the special objective of DTCs must be considered during the interpretation process. DTCs should restrict or remove domestic situations which lead to taxation. This goal can only be reached if there is a close connection between the DTC provisions and the rules of domestic law. In order to be able to impose the restrictive or removing legal consequence, the DTC must cover the domestic rule that is intended to be restricted or removed. For this reason, there must be a connecting factor between domestic law and DTC law. In accordance with the structure of the domestic provision, the connecting factors of the DTC cover the personal and factual content of the tax liability.

79 The **references to taxpayer and tax base** in the convention are linked to the domestic laws of the contracting states and must therefore be understood as a dynamic cross reference because the DTC provisions refer to applicable law of the two contracting states. Thus, if the treaty mentions the term "person", this is to be understood with reference to the respective applicable legal provisions of the contracting states, which regulate the liability to pay taxes. The expressions "profit", "income" and "assets" refer to established law of the contracting states, which describes the factual part of the taxation situation. In the personal as well as in the substantial sense, the structure of the DTC requires a reference to domestic law.

80 ***Example:*** *A Greek lawyer visits a client in Switzerland to provide legal advice but does not have an office in Switzerland. Pursuant to Art. 14(1) of the Greece–Switzerland DTC (Art. 14 of the former OECD Model), the income derived by the lawyer is taxable only in Greece unless the lawyer has a fixed base regularly available to him in Switzerland. Consequently, the income is taxable only in Greece. With respect to the concept of "income", Greek domestic law will determine the taxable base with regard to the factors to be taken into account in determining income.*

81 Some individual DTC provisions contain an express **reference to domestic law**. Several provisions refer to the domestic law of one of the two states. The other

contracting state must abide by the interpretation of the state to which the provision refers.

82 ***Example:*** *Under Art. 6(2) OECD Model, the term "immovable property" shall have the meaning which it has under the law of the contracting state in which the property in question is situated. Consequently, the interpretation of the situs state is decisive. The legal situation of the situs state is also decisive for the interpretation of the DTC in the residence state.*

83 Some bilateral DTC provisions deviate from the wording of the OECD Model provisions as a consequence of the legal situation in one or both contracting states at the time of the conclusion of the treaty. This can arise in cases in which provisions of a DTC contain wording which is identical to that found in **domestic law at the time of conclusion of the treaty**. In this case, what must be determined is whether these conceptual parallels are merely accidental or whether the DTC negotiators intended to refer to the domestic law meaning. If this connection was intended, the meaning of the term in domestic law at that time prevails. Consequently, in these cases the reference to established law is static, i.e. the provision is to be given the meaning it had at the time of conclusion of the treaty.

84 ***Example:*** *Several Japanese tax treaties recently concluded contain special provisions for income from "tokumei kumiai", the Japanese silent partnership. This stems from the fact that in absence of such a provision this type of income would be qualified as "other income", which is taxable only in the recipient's residence state. The result of this loophole was artificial constructions that took advantage of the Japanese silent partnership (cf. Matsubara, Asia Pacific Tax Bulletin 2004, 76). Articles concerning the tokumei kumiai provide that the income may be taxed where it arises, i.e. in Japan.*

2.3 The importance of the OECD Model and its Commentary

85 The OECD Model and the Commentary of the OECD Committee on Fiscal Affairs are very important in the interpretation of tax treaties. According to Art. 31(4) VCLT, a special meaning can be attributed to a term if it is established that the parties so intended. It can be argued that the parties so intended when they adopted the text of the OECD Model without changes. The OECD Model and the Commentary primarily form part of the **historical interpretation materials**.

86 The OECD Model and the Commentaries do **not**, however, have **as much weight as the wording of the convention** itself because they are not part of the agreement. In addition to the OECD Model and the Commentary, other historical, teleological and systematic aspects, as well as the wording of the convention itself, have to be taken into account. Which arguments are more convincing is to be evaluated on a case-by-case basis. Art. 31 VCTL does not provide for a rule under which one interpretation method takes precedence over another.

87 ***Example:*** *A company resident in the United Kingdom was engaged in the transportation of goods by international shipping and had, amongst others,*

an agent in India, who arranged cargo and shipping activities on ships of the UK company as well as on ships operated by third parties. Under Art. 9(1) of the India–UK DTC (Art. 8 OECD Model) "income of an enterprise of a Contracting State [UK] from the operation of ships in international traffic shall be taxable only in that State". Consequently, the UK company claimed that its activities were not taxable in India. The Indian tax authorities argued, however, that the income relating to the activities carried on by ships operated by third parties was not income from the "operation of ships". The UK company appealed. The phrase "operation of ships" was not defined in the India–UK DTC. The ITAT therefore relied upon the Commentary in force at the time of conclusion of the treaty because the wording of the DTC was similar to that of the OECD Model. The Tribunal referred to the OECD Commentary on Art. 8, holding that freight income was income from the operation of ships and exempt from tax in India (IN, ITAT 13 Aug. 2008, DDIT v. Balaji Shipping).

88 In the opinion of some tax authorities, the OECD Model and the Commentary of the OECD Committee on Fiscal Affairs should also be taken into account for the interpretation of DTCs that **do not follow the OECD Model**. In my view, there are no grounds for taking the OECD Model or the Commentary into account when interpreting DTCs which do not follow the OECD Model. If the contracting states did not use the OECD Model as a guideline for their bilateral agreement, it cannot be assumed that they understood the provisions of the treaty in the same way as the OECD Model or the Commentary do.

89 ***Example:*** *A German teacher worked at a school in Spain and received her salaries from German public funds. She rendered her services not to Germany but at least in Germany's public interest. The taxpayer argued that she was not taxable under Art. 18 of the Germany–Spain DTC (government services), because she did not render her services to the state and therefore was not liable to German income tax. In interpreting the respective provision, the German Federal Tax Court stated that, since Art. 18 of the treaty does not exactly correspond to Art. 19 OECD Model, the OECD Commentary cannot be taken into account. Instead, the court interpreted the case exclusively on the basis of the wording of the Germany–Spain DTC. (GE, BFH 13 Aug. 1997, I R 65/95)*

90 Occasionally, the domestic legal situation existing at the time of conclusion of the treaty is considered in the interpretation of DTCs that **follow the OECD Model**. In my view, this practice is incorrect. If the DTC negotiators transferred a wording contained in the OECD Model to the bilateral DTC, it is to be assumed that they wanted this wording to have the same meaning as it has under the decisive provision of the OECD Model. Without any evidence, it cannot therefore be assumed that the understanding of the treaty is based on the domestic understanding of one of the two contracting states at the time of conclusion of the agreement.

91 ***Example:*** *An individual resident in Austria was the manager of a Swiss company and owned 95% of the shares of that company. In 1974, the DTC between Austria and Switzerland came into force. At that time, Austrian tax law did not include a rule according to which a participation higher than 25% is decisive for the characterization of income of the shareholder-manager as independent personal services, as opposed to employment income. This rule was only later introduced in Austrian tax law. The Austrian Supreme Administrative Court (VwGH) took into account the domestic legal situation at the time of the conclusion of the DTC and concluded that income derived by the individual was covered by Art. 15 of the Austria–Switzerland DTC (cf. AT, VwGH 20 Sep. 2001, 2000/15/0116; for a similar conclusion cf. e.g. AT, VwGH 21 May 1997, 96/14/0084; for different conclusion drawn earlier cf. AT, VwGH 31 Jul. 1996, 92/13/0172).*

2.4 The importance of changes in the OECD Model and its Commentary

92 The OECD Model on income and on capital exists in **different versions**. The first version was published in 1963, the second in 1977 and the third in 1992. Since then, the OECD Model has been continuously revised (cf. m.no. 25). The same is true for the Commentary. Scholars discuss which version of the OECD Model and of the Commentary should be used for the interpretation of DTCs.

93 The Introduction to the OECD Model states that existing DTCs should, as far as possible, be **interpreted in the spirit of the revised Commentary**. It specifies that amendments to the articles and resulting changes to the Commentary are not relevant to the interpretation or application of previously concluded DTCs where the provisions of those DTCs are different in substance. Where, however, changes or additions to the Commentary are not different in substance, they are normally applicable to the interpretation and application of DTCs concluded before their adoption because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations.

94 This approach has been convincingly criticized by some commentators, as these **later versions of the Commentary** have not been considered by the parliament who approved the DTC. Later versions of the Commentary are not "context" for the purpose of Art. 31(1) VCLT because only Commentaries that are made in connection with the conclusion of the treaty can be considered context. They cannot be considered "subsequent agreements" for the purposes of Art. 31(3) VCLT since that would require parliamentary approval. In order to be considered "subsequent practice" within the meaning of Art. 31(3) VCLT, evidence would be required to show that the Commentary reflected actual subsequent practice of both contracting states; relying on the words of the OECD Commentary would not suffice for this purpose. Finally, later changes to the Commentary cannot be considered "special meaning" within the meaning of Art. 31(4) VCLT since the parties could

not have intended an interpretation that did not exist at the time the DTC was concluded (cf. Vogel, *BFIT* 2000, 612; cf. also Wattel/Marres, *ET* 2003, 222).

95 It has, however, been pointed out that refusing to take later Commentaries into account can result in the Commentaries being frozen in time and therefore failing to adapt to changes in business or technology. If later Commentaries are not used, the result could be a **different interpretation** of identical wording in treaties entered into at different times. This goes against the goal of uniform interpretation of DTCs (cf. Avery Jones, *Bulletin – Tax Treaty Monitor* 2002, 102; Baker, *DTC* Introd., E.15).

96 The fact remains, however, that adopting later Commentaries would interfere with the **competence of the legislative bodies**. A change in the Commentary can never overrule an existing DTC. If the interpretation of a DTC inevitably leads to a result which deviates from the Commentary, this interpretation will legally prevail (Wattel/Marres, *ET* 2003, 222).

97 For all these reasons, only the version of the OECD Model and the respective Commentary **existing at the time of conclusion of the corresponding DTC** can be considered for the interpretation of a DTC that follows the OECD Model, since the DTC negotiators could only have an understanding of the version of the Commentary existing at that point in time. It cannot therefore be assumed that they attached a meaning to a DTC provision which it only acquired in a later version of the Commentary (affirmative, Vogel, *SWI* 2000, 109; Wassermeyer, in Debatin/Wassermeyer *Musterabkommen* Vor Art. 1, m.no. 60; Ward, in Douma/Engelen (eds.), *Legal status*, 86).

98 ***Example:*** *In CA, TCC 18 Aug. 2006, MIL Investments SA v. Her Majesty the Queen, the taxpayer was a company resident in the Cayman Islands that held shares in a Canadian corporation. The taxpayer was relocated to Luxembourg. He then sold the shares in the Canadian corporation and claimed an exemption under the Canada–Luxembourg DTC of 1990. The tax authorities denied the exemption under the general anti-avoidance rule (GAAR) of the Canadian Income Tax Act, which is, according to Canadian domestic law, applicable to DTCs. The Tax Court of Canada ruled that the GAAR did not apply since the transactions were not avoidance transactions. The tax authorities then argued that the DTC contained an inherent anti-abuse rule which applied in this case to deny the exemption. The tax authorities relied on the 2002 OECD Commentary in support of the argument that the DTC contained an inherent anti-abuse rule. The 1977 OECD Commentary on Art. 1 stated, however, that if contracting states wanted to have an anti-abuse provision in the DTC, such a provision should be included in the DTC. The Tax Court ruled that only the Commentary from 1977 was relevant for the interpretation of the 1990 DTC and agreed with the taxpayer that there was no inherent anti-abuse provision in the DTC. In other words, the court was of the opinion that statements found in the Commentary from 2003 had no effect on the interpretation of Canada's 1990 DTC with Luxembourg.*

99 The fact that a particular version of the Commentary was altered or supplemented does not always mean, however, that a DTC concluded before that version of the Commentary was published has a **different content**. It is possible that that version confirms an opinion which could be deduced from the version of the OECD Model existing at the conclusion of the relevant DTC, by means of historical, systematic or teleological arguments. In this case, the opinion represented in the later version of the Commentary can apply to the interpretation of DTCs concluded before that version was published. The reason for this is not that the opinion was explicitly set out in the Commentary but that it could already be established by interpretation.

100 ***Example:*** *In CA, FCA 26 Feb. 2009, Prévost Car Inc. v. Her Majesty the Queen, a Canadian company paid dividends to its shareholder in the Netherlands. The issue was whether this shareholder was the "beneficial owner" of the dividends for the purposes of Art. 10 of the 1986 Canada–The Netherlands DTC. Under this DTC, if this shareholder was the beneficial owner, the withholding tax would be limited to 5%. In the view of the tax authorities, the beneficial owner was not the shareholder located in the Netherlands but the parent corporations of the Netherlands company. These parent corporations were located in Sweden and in the United Kingdom, and under the DTCs between Canada and those countries, the withholding tax rates were 15% (Sweden) and 10% (UK). The court upheld the Tax Court's decision that the beneficial owner was indeed the shareholder in the Netherlands. In doing so, it stated the following: "[...] for the purposes of interpreting the Tax Treaty, the OECD Conduit Companies Report (in 1986) as well as the OECD 2003 Amendments to the 1977 Commentary are a helpful complement to the earlier Commentaries, insofar as they are eliciting, rather than contradicting, views previously expressed."*

101 This view that only the Commentary existing at the time of the conclusion of the DTC may be used in the interpretation of the latter (cf. m.no. 94 et seq.) does not mean that later versions of the Commentary are completely irrelevant. Undoubtedly, the members of the working parties and the OECD Committee on Fiscal Affairs are highly qualified experts. More recent versions of the Commentary are therefore of importance as **expert opinions**. They have the same relevance as papers and other scientific publications; they can influence the understanding of provisions in practice, if the arguments are convincing. Frequently, however, the Commentary only presents the result of a certain interpretation without reference to the main arguments that led to this result. Consequently, they often lack the persuasiveness necessary for influencing practice.

102 In some cases, however, a more recent version of the OECD Commentary can be helpful in the interpretation of an older DTC because that **version reflects practice** already common in some areas. The first OECD Model and Commentary from 1963 were not created overnight but followed existing bilateral treaty practice. Provided that a version of the OECD Model or the Commentary actually

reflects bilateral practice, these materials can also be useful for the interpretation of later DTCs.

103 ***Example:*** *In CA, FCA 19 Oct. 1998, Cudd Pressure Control Inc. v. Her Majesty the Queen, the issue was the independence of the PE under the 1942 Canada–US DTC. The court justified taking the later OECD Commentaries into account as follows: "The relevant commentaries on the OECD Convention were drafted after the 1942 Convention and therefore their relevance becomes somewhat suspect. In particular, they cannot be used to determine the intent of the drafters of the 1942 Convention. However, although the wording and arrangement of the provisions are significantly different in the two Conventions, the 1942 Convention follows the same general principles as the OECD Model. The OECD Commentaries, therefore, can provide some assistance in discerning the 'legal context' surrounding double taxation conventions at international law, and in particular in ascertaining when it is appropriate to allow a deduction for a notional expense." In this case the court's proceedings, in my opinion, were feasible and well founded. The provisions of Art. 7 OECD Model were based on the work of Mitchell B. Carroll and it can therefore be assumed that the negotiators of the DTC in question were also influenced by these considerations (cf. also Vogel, DTC Art. 7, m.no. 68).*

104 When an amended version of the Commentaries of the OECD Committee on Fiscal Affairs provides an opinion regarding the interpretation of a provision of the OECD Model that cannot be derived from the former version of the OECD Model by means of general principles of interpretation, this change causes the **content of the existing DTCs to drift apart**. For the interpretation of a DTC, the version of the OECD Model and the Commentary available at the time of conclusion of the bilateral DTC must be used. This development is regrettable considering the fact that DTCs are gaining more and more importance. It would therefore be desirable for the OECD Committee on Fiscal Affairs to effect changes in the OECD Model and the Commentary at wider intervals after having thought twice and after having intensely discussed the change. In practice, the frequent changes of the OECD Model and the Commentary of the OECD Committee on Fiscal Affairs lead to an increase in interpretation conflicts, since in some states, courts are quite inclined to at least partially follow more recent versions of the OECD Commentary when interpreting older DTCs (cf. for the discussion in Norway e.g. Zimmer, in Lang (ed.), *Interpretation*, 266). The fact that since 1992 the OECD has published the OECD Model and the Commentary in loose-leaf format intensifies this issue, since older versions become harder to obtain or are even forgotten. However, many of those applying the law are not always willing to follow the most recent version of the Commentaries without legal authority (cf. e.g. Michelsen, in Lang (ed.), *Interpretation*, 72, discussing a Danish court decision from 3 Feb. 2000). Provisions of the very same treaty are therefore more frequently understood differently. Altogether, the authority of the OECD Commentary has suffered considerably from the repeated changes.

2.5 The importance of OECD reports

105 The OECD Committee on Fiscal Affairs' Working Parties frequently work on controversial or insufficiently discussed DTC issues and write "**OECD reports**". After approval by the OECD Committee on Fiscal Affairs, these reports are usually published. They often provide reasons for changes to the OECD Model or the Commentary.

106 If the reports have been the reason for changes in the OECD Model or the Commentary, they are a useful reference **for understanding the changes**. They must be taken into account in the interpretation of those DTCs which follow the OECD Model or a particular Commentary that was changed on the basis of the OECD report.

107 The OECD reports can even be relevant for the interpretation of a DTC if they were available at the time of conclusion of a DTC that follows the OECD Model and if it can be assumed that the negotiators of the DTC were **aware of the opinion represented in the OECD report and shared it**. However, the assumption that the negotiators of the DTC followed the opinion represented in an OECD report is not as obvious as it is when it comes to the Commentary. Occasionally, however, the OECD Commentary refers to an OECD report. In these cases it can be assumed that if the negotiators followed the OECD Model and the Commentary, they also took into account the opinion set out in the report as represented in the Commentary.

108 **Later OECD reports**, however, are, like a later OECD Commentary (cf. m.no. 92 et seq.), not to be taken into account for the interpretation of older DTCs because it cannot be assumed that the negotiators of the DTC based their understanding of certain DTC provisions on opinions of a version of the Commentary that had not yet been developed at the time of the conclusion of the treaty. Well-founded opinions in the OECD Commentary are relevant, however, as expert opinions, in the same manner as opinions of other experts.

2.6 The importance of administrative practice

109 The tax administrations of two contracting states frequently seek agreement on the interpretation of DTC rules. They enter into "**mutual agreements**" with respect to a common interpretation of a certain treaty provision. The tax administrations occasionally expect that these mutual agreements, like the DTC provisions, will be binding on all parties. In practice, mutual agreements are therefore important.

110 However, interpretative mutual agreements are **not binding** on courts (cf. Vogel, *DTC* Art. 25, m.no. 105; Avery Jones, in Maisto (ed.), *Courts*, 78 et seq.; for a different view, cf. Ward, in Douma/Engelen (eds.), *Legal status*, 81). Courts would only be bound by the content of a mutual agreement if a domestic law provision provides for this (Avery Jones, in Maisto (ed.), *Courts*, 78) and if the mutual agreement were given legal effect by subsequent legislation.

111 ***Example:*** *The Italian and German tax administrations agreed that Art. 7(2) of the Germany–Italy DTC (1925), dealing with government services, was not applicable to an employee working in Germany for an Italian bank, which was a public corporation under Italian law. They established by mutual agreement that Art. 7(2) was not applicable because the employee did not render services of a governmental nature in Germany. The German Federal Tax Court disagreed with this opinion and came to the conclusion that it does not depend on the tasks of the employee but on the public employment itself (GE, BFH 1 Feb. 1989, I R 74/86). The agreement of the two tax administrations did not have any binding effect on the high court. The mutual agreement did not therefore prevent the German Federal Tax Court from deciding the case in a different way. (Similar conclusions were reached in the UK, HCCD 9 Feb. 1990, Commerzbank AG and Banco do Brasil SA* v. *Inland Revenue Commissioners)*

2.7 The importance of other countries' court decisions

112 Courts, authors and tax authorities often consider foreign court decisions regarding treaty interpretation. Foreign court decisions can provide useful guidance with respect to **how other countries interpret and apply** a particular provision. Foreign court decisions are also often explicitly cited by a court interpreting the same provision. Furthermore, when national courts give important treaty interpretations, the OECD discusses them to determine whether the interpretations are correct with respect to the wording of the OECD Model (cf. Sasseville, in Maisto (ed.), *Courts*, 189).

113 Foreign court decisions, however, are **not formally binding** on a court. The weight to be given to them may vary for a number of reasons. If the decision was not rendered by the highest court of the foreign jurisdiction, it may be given less weight. If the decision was based on a later version of the OECD Commentary, care must be taken to ensure that the court does not inadvertently adopt a later Commentary and give it the same weight as the existing Commentary. Additionally, there is no assurance that the foreign court has decided the matter correctly or has given the provision a correct interpretation. (Ward, in Maisto (ed.), *Courts*, 161). Summing up, the relevance of a foreign court decision depends on how convincing its reasoning is.

3. The importance of interpretation rules set out in DTCs

3.1 Art. 3(2) OECD Model

114 The OECD Model contains an **independent interpretation rule** in Art. 3(2), which reads as follows: "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that

State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

115 ***Example:*** *Under the Ireland–Italy DTC, a person is a resident of Italy if this person is resident in that state for the purposes of Italian tax and is either not resident in Ireland for the purposes of Irish tax or, if resident in Ireland, is present therein for a period or periods not exceeding in the aggregate 91 days in the fiscal year. In High Court of Ireland 31 Jul. 2007, Kinsella v. Revenue Commissioners, the issue was the meaning of the terms "days" and "fiscal year", i.e. whether they should be given meanings as determined either by Irish domestic law or by Italian domestic law, or different meanings since the context otherwise requires.*

116 The content of this rule is highly controversial and has been discussed extensively in international tax literature (cf. Engelen, *Interpretation*, 474, with further references). One could claim that, pursuant to Art. 3(2), **domestic law is decisive**. This interpretation, however, overlooks the fact that according to the wording of Art. 3(2) OECD Model, the domestic law of the contracting states is decisive "unless the context otherwise requires". The concept of "context" therefore is determinant. Its meaning, like the meaning of Art. 3(2) OECD Model in its entirety, needs to be determined according to international law principles of interpretation. Consequently, if the object and purpose of a DTC, which are primarily decisive under Art. 31(1) VCLT, are taken into account, this leads to a broad understanding of the concept of "context" in Art. 3(2) OECD Model. DTCs can only fulfil their purpose, i.e. the allocation of taxing rights, if the tax authorities of both contracting states understand terms in the same way. Falling back to the domestic law of the respective contracting state would conflict with this purpose. Thus, the reference to domestic law contained in Art. 3(2) OECD Model should be understood as restrictively as possible and the concept of "context" in Art. 3(2) OECD Model should be interpreted widely. Namely, the concept of "context" should comprise all of the interpretation materials set out in Art. 31 et seq. VCLT. Historical arguments support this view. The reference to domestic law in Art. 3(2) OECD Model is therefore only important if the application of all possible interpretation methods does not lead to a satisfying solution. However, if all systematic, teleological and historical aspects are taken into account for the interpretation, this will be very rare.

117 ***Example:*** *Art. 16 of the DTC between Austria and Switzerland applies to income earned by a member of the board of directors or supervisory board. On the basis of Art. 3(2) of the Austria–Switzerland DTC, one could conclude that domestic law should be considered in order to establish the meaning of the terms "member of the board of directors" and "member of the supervisory board". However, if one takes historic and systematic aspects into account, the OECD Commentary suggests the following: only primarily*

supervising activities should be covered by treaty provisions patterned after Art. 16 OECD Model. Therefore, if a board of directors with operational activities is in question, the earnings derived by a member of that board are not covered by provisions patterned after Art. 16 OECD Model, despite the term "board of directors" (accordingly, AT, VwGH 31 Jul. 1996, 92/13/0172).

118 According to these considerations, Art. 3(2) OECD Model has **no legal significance**. This provision merely emphasizes what is valid according to the interpretation principles of international law: a solution should first be sought on the basis of the systematic, the objective and the historical development of the treaty, and only when this fails can one refer to domestic law. Art. 3(2) OECD Model merely confirms this. The rule therefore is dispensable. If it were simply abolished, nothing would change. Given its controversial content, some writers have proposed either to fundamentally revise it or to remove it from the OECD Model (Vogel/Prokisch, in IFA (ed.), *Interpretation*, 84).

119 Given the opinion represented here, it is not important whether the reference to domestic law is to be understood **dynamically or statically**. Since the 1995 update of the OECD Model, Art. 3(2) OECD Model explicitly states that the reference to domestic law is to be understood dynamically. This means that the legal situation existing at the time of the application of the DTC must be taken into account. However, prior to the change in 1995, systematic arguments did not support an understanding of the references to domestic law as a static reference. Thus, even before 1995, prevailing opinion was not to refer to domestic law of the point in time of conclusion of the treaty.

120 ***Example:*** *A Spanish resident company paid royalties to various US resident companies for the right to use computer software combined with the provision of technical assistance. Under the treaty signed in 1990 between Spain and the United States, royalties may be taxed in the source state. However, the maximum tax rate depends on the type of royalty. Under Art. 12(2) Spain–US DTC, royalties paid for the use of copyright of literary work may be taxed at source at a rate of 5%, royalties paid for the use of copyright of scientific work may be taxed at a rate of 8% and royalties paid in any other case may be taxed at a rate of 10%. The 1990 Spain–US DTC includes a provision patterned after Art. 3(2) OECD Model. In a decision rendered on 17 Apr. 2008 (ES, TEAC, 17 Apr. 2008, 3604/2006), the Spanish Tribunal Económico-Administrativo Central concluded that royalties for the right to use computer software combined with the provision of technical assistance do not correspond to royalties for the use of copyright of literary or scientific work and therefore may be taxed in Spain at a rate of 10%. The court based its decision on Art. 3(2) of the 1990 Spain–US DTC and made reference to the definition of royalty adopted in Spanish domestic law in 2002. Noticeably, the court accepted that the reference to domestic law under Art. 3(2) of a treaty concluded prior to the 1995 update of the OECD Model was dynamic.*

Another controversy relates to the question of whether both contracting states are **"user states" for the purpose of Art. 3(2) OECD Model**. A group of authors coordinated by Avery Jones advanced the view that the treaty is only applied in the source state and, consequently, the reference to domestic law of the "user state" contained in Art. 3(2) OECD Model leads to the situation that the residence state is bound by the qualification of the source state (Avery Jones et al., *BTR* 1984, 48 et seq.). This interpretation, however, has not been generally accepted because the residence state also applies the DTC. In order to be able to determine the legal consequences resulting from the method article, the residence state must also apply an allocation rule (cf. in detail and convincingly Vogel, *DTC* Art. 3, m.no. 65 et seq.). **121**

3.2 The binding qualification of the source state according to Art. 23(1) OECD Model

Over the last few years, other efforts to gain a uniform understanding of the terms used in DTCs in both contracting states have been undertaken. One main topic has been that of "conflicts of qualification", i.e. conflicts regarding the classification of a certain item of income for tax treaty purposes. These conflicts can be resolved if the residence state accepts the **qualification by the source state**. The legal basis for this is seen in DTC provisions patterned after Art. 23(1) OECD Model. This measure provides that the residence state shall either exempt the income or credit the foreign taxes paid on the income, where such income "may be taxed in the other Contracting State" in accordance with the provisions of the convention. This opinion was advanced by Déry/Ward (in IFA (ed.), *Interpretation*, 259 et seq.), then developed by the group of authors coordinated by Avery Jones (*ET* 1996, 126 et seq.) and eventually included in the OECD Commentary in 2000 (OECD Commentary on Art. 23, para. 32.1 et seq.). **122**

Opposing arguments have been made in relation to this interpretation of Art. 23(1) OECD Model. In the first place, the wording of Art. 23(1) OECD Model does not imply that the determination of whether "income … may be taxed in the other Contracting State … in accordance with the provisions of this Convention" is to be made exclusively from the source state's point of view. Rather, Art. 23 OECD Model focuses on the residence state, such that the persons applying the DTC in the residence state must establish whether the income may be taxed "in accordance with the provisions of this Convention" in the other contracting state, irrespective of the domestic legal situation in that state. This is, for example, the advantage of the exemption method, "since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State" (OECD Commentary on Art. 23, para. 34). This advantage would not exist if the persons applying the DTC in the residence state had to take into account the domestic legal situation in the source state in order to recognize the right to the exemption. In addition, the exceptions to the characterization of the source state **123**

occasionally contained in the allocation rules (e.g. Art. 6(2) and Art. 10(3) OECD Model) would become superfluous if Art. 23(1) OECD Model would lead in every case to the reference to the characterization of the source state. Finally, the exemption by the residence state does not always result from Art. 23 OECD Model but occasionally from the allocation rule itself, as Art. 19 OECD Model demonstrates.

124 However, the OECD Commentary on Art. 23 assumes the binding effect of the characterization of the source state **only when it originates in its domestic law** (OECD Commentary on Art. 23, para. 32.3; cf. also para. 32.5). It would therefore be necessary to distinguish between those cases in which the source state wins the characterization under the context of the treaty and those cases in which the source state is required to refer to domestic law definitions. Only in the latter should the source state's characterization have a binding effect. However, this presupposes that the demarcation between the two groups of cases is clear. In practice, the situation is the reverse. The question of whether the context of the treaty requires a certain result or not can be raised in every case (m.no. 32.4). The issues that arise as regards Art. 3(2) OECD Model would then play a role in the interpretation of Art. 23(1).

125 ***Example:*** *In LU, CA 23 Apr. 2002, case 14442, the court had to determine which allocation rule, of those contained in the France–Luxembourg DTC, was applicable. Under the facts, a Luxembourg resident company owned real estate in France and had applied, to the income deriving therefrom, Art. 3 (immovable property) of the France–Luxembourg DTC, which granted exclusive taxing rights to France. The company did not therefore pay tax to Luxembourg on this income. Moreover, the company did not pay any tax to France because according to Conseil d'État jurisprudence, based on the interpretation of the treaty itself and not on French domestic law, income derived from immovable property owned by a company is covered by Art. 4 of the France–Luxembourg DTC on business profits. In this case, Art. 4 Luxembourg–France DTC attributed exclusive taxing rights to Luxembourg since the Luxembourg resident company did not have a PE in France. Confirming the decision of the lower court, the Cour Administrative held that the characterization of the income by the source state (France) was not binding on Luxembourg, not even if double non-taxation would arise. Noticeably, the characterization given by the French Conseil d'État was not based on French domestic tax law but rather on the interpretation of the treaty.*

126 The interpretation proposed by the OECD Commentary on Art. 23 would mean that **conflicts of qualification are resolved at the expense of the residence state**. This can be understood by the tax authorities of the source state as an invitation to extend taxing rights. However, the tax authorities of the residence state would fight against attempts of the tax authorities of the source state to expand taxing rights through the characterization under domestic law in the interpretation of the DTC.

In order to avoid the expansion of the taxing rights of the source state at the expense of the residence state, the latter will try, if needed, to reject the argument of the binding effect of the characterization of the source state if it procures taxing rights. Thus, if the interpretation proposed by the OECD Commentary with respect to Art. 23(1) was followed in practice, conflicts of qualification and the double taxation arising from them would not only remain but could even increase.

127 ***Example:*** *A Belgian professor holds a 2-day lecture as guest professor at an Austrian public university. According to Sec. 25(1)(5) of the Austrian Income Tax Act, the income that the scientist derives from this activity is income from employment. Referring to Art. 3(2) of the Austria–Belgium DTC, the Austrian tax authorities use this characterization on the treaty level and apply Art. 19 of the treaty (cf. Hofbauer, in Lang (ed.), Interpretation, 32). Consequently, the Austrian tax authorities believe that the income is taxable in Austria and expect the Belgian authorities to follow this characterization. However, it will be difficult to explain to the Belgian authorities that a 2-day lecture held in Austria should constitute employment in terms of the DTC and it is unlikely that they will understand the Austrian legal situation. Since Belgium would lose its right to tax if it followed the Austrian domestic characterization, the Belgian tax authorities may prefer to characterize the income based on the tax treaty only, pursuant to which they will apply Art. 14 of the DTC, as opposed to Art. 15 or 19. If Austria is not obliged to interpret the DTC according to Austrian law, the OECD Commentary provides that Belgium is not bound by the characterization of the source state. In this way Belgium would, due to the lack of a fixed base in Austria, secure its taxing right. This would result in double taxation (cf. Gassner/Lang, in: Vanistendael (ed.), Liber amicorum Hinnekens, 219 et seq.).*

128 It is doubtful, whether the **interpretation of DTCs** should be based on the view stated in the OECD Commentary on Art. 23 that the residence state is legally bound in certain cases by the qualification of the source state. According to the opinion represented here (cf. m.no. 92 et seq.), this view can only be taken into consideration with respect to those DTCs that were negotiated and completed after the publication of the 2000 OECD Model and the Commentary. In addition, for the interpretation of these DTCs, the OECD Commentary is not the single means of interpretation. Remarkable systematic and teleological arguments counter the opinion set out in the Commentary on Art. 23 (cf. m.no. 123). In addition, the OECD Commentary itself does not clearly express which situations are covered by the binding effect of the characterization of the source state (cf. m.no. 124). For all these reasons, it follows that the binding effect of the characterization of the source state on the residence state cannot be relevant for the interpretation of even the more recent DTCs.

129 The interpretation of Art. 23(1) OECD Model proposed by the OECD Commentary also addresses the purpose of **avoiding double non-taxation** through

the uniform application of the DTC definitions in both contracting states, to the extent that the conflict is due to differences in the domestic law between the source state and the residence state (OECD Commentary on Art. 23, para. 32.6 read in the light of para. 32.3).

130 In line with the purpose of avoiding cases of double non-taxation, a new **paragraph 4** was included in Art. 23A OECD Model in 2000. According to this new provision, the exemption shall not be granted by the residence state where the other contracting state applies the provisions of the convention to exempt income (or capital) from tax or applies the provisions of para. 2 of Art. 10 or Art. 11 OECD Model. The rule in Art. 23(4) OECD Model gives the residence state the right to switch from the exemption to the credit method when the interpretation of facts or of the provisions of the DTC leads the source state to exempt or to impose nominal taxes (because it applies Art. 10(2) or Art. 11(2) OECD Model) on a certain item of income. If the double non-taxation is based on the interpretation of domestic law of the source state, Art. 23(4) OECD Model is not applicable (cf. Kolb, *ASA* 2001, 868 et seq.). Some authors, however, question whether this provision has any significance at all (cf. Bauer/Schuch, in Gassner/Lang/Lechner (eds.), *Personengesellschaften*, 41 et seq.).

3.3 The relevance of later commentaries

131 Some recent DTCs contain a **specific interpretation rule** which establishes that later commentaries are to be taken into account. In one of the DTCs recently concluded by the Netherlands, for example, this rule reads as follows: "It is understood that the provisions of the Convention which are the same or substantially the same as the corresponding provisions of the OECD Model Tax Convention on Income and on Capital, shall be interpreted according to the OECD Commentary on these provisions at the moment of signing the Convention and to subsequent clarifying modifications of the OECD Commentary on these provisions" (Protocol to the Bahrain–Netherlands DTC, para. A.1.). This provision results from the Netherlands' treaty policy according to which tax treaties have to be interpreted in a dynamic way (cf. De Bont, in Lang (ed.), *Interpretation*, 246 et seq.). In the DTCs recently signed by Belgium, a slightly different rule can usually be found: "In the interpretation of the provisions of the Agreement which are identical or in substance similar to the provisions of the OECD Model Tax Convention, the tax administrations of the Contracting States shall follow the general principles of the commentary of the Model Convention provided the Contracting States did not include in that commentary any observations expressing a disagreement with those principles and to the extent the Contracting States do not agree on a divergent interpretation in special circumstances" (para. 2 of the Protocol to the Belgium–Tajikistan DTC; para. 1 of the Protocol to the Belgium–Moldova DTC; similar also para. 8 of the Protocol to the Belgium–Isle of Man DTC).

132 Some recent **Austrian tax treaties** also include a specific interpretation rule, which usually reads as follows: “It is understood that provisions of the Convention which are drafted according to the corresponding provisions of the OECD-Model Convention on Income and on Capital shall generally be expected to have the same meaning as expressed in the OECD Commentary thereon. The OECD Commentary – as it may be revised from time to time – constitutes a means of interpretation in the sense of the Vienna Convention of 23 May 1969 on the Law of Treaties” (cf. e.g. para. 6 of the Protocol to the Austria–Bulgaria DTC 2009; para. 1 of the Protocol to the Austria–Bosnia and Herzegovina DTC 2008; para. 5 of the Protocol to the Albania–Austria DTC 2007).

133 The meaning of this rule is unclear. It is unquestionably intended to **ensure that the OECD Commentary is taken into account** but it is not clear whether it provides the required authority to always refer to the latest version of the OECD Commentary (e.g. this is what the Austrian tax authorities held, cf. Loukota, *SWI* 1995, 450 et seq.). In fact, its wording is not clear since it does not specify the version of the Commentary to which reference should be made. A clear conclusion cannot even be derived from the provision which reads that the OECD Commentary – as it may be revised from time to time – constitutes a means of interpretation in the sense of the VCLT.

V. Treaty abuse

1. Denial of treaty benefits

Great controversy exists among tax scholars with respect to whether tax authorities may prevent the **improper use of DTCs**. The discussion focuses, on the one hand, on what constitutes abuse and is thus undesirable and, on the other, on the rules empowering tax authorities not to grant treaty benefits. **134**

Example: *A company incorporated in Israel decided to move its registered office to Belgium. When its Israeli subsidiary distributed a dividend to the parent company, which was at that point in time already resident in Belgium, the company claimed a reduced withholding tax rate under the Belgium–Israel DTC. The Israeli tax authorities, however, disregarded the change in residence arguing that the registration in Belgium was a sham and was only driven by motives of tax avoidance. Under Israeli domestic law, tax officers are entitled to disregard a transaction if it is artificial or fictitious. Consequently, the company was not granted the benefits from the treaty and appealed to the Israeli District Court. The court, however, confirmed the tax authorities' position and allowed them to counter treaty abuse by not applying the tax treaty (IL, DC 30 Dec. 2007, Yanko-Weiss Holdings [1996] Ltd. v. Assessing Officer of Holon, 5663/07).* **135**

2. The application of domestic anti-abuse principles?

In most countries, taxes cannot be avoided or reduced through abuse. **Domestic tax laws** contain provisions or principles pursuant to which transactions are disregarded or recharacterized if they are abusive. Often, an abuse exists when the arrangement or transaction is artificial or uncommon and it was entered into solely for the purpose of a tax benefit. **136**

The courts of some countries apply the principle of "**substance over form**" to disregard the legal form of a transaction in favour of its true economic substance (e.g. in the US). In many civil law countries a general prohibition against the abuse of law ("fraus legis") exists (e.g. in Austria, France, Germany, the Netherlands, Spain, Sweden and Switzerland). Finally, some countries have enacted a general anti-avoidance rule, which permits the recharacterization of transactions designed to circumvent the tax laws in order to achieve a tax benefit (e.g. in Australia, Canada and South Africa) (cf. Vogel, *DTC* Art. 1, m.no. 78 et seq.). **137**

Domestic anti-abuse legislation does **not**, in my opinion, apply to **deny treaty benefits**. DTC law and domestic law are, for the purposes of interpretation, separate legal systems. When domestic anti-abuse rules apply to extend the taxable basis, the treaty protection still exists. DTCs set out the situations in which the domestic right to tax is reduced, eliminated or maintained. This function would be lost if it were to be interpreted by reference to domestic anti-abuse rules. Consequently, **138**

domestic anti-abuse rules may not be applied to DTCs. This conclusion is affirmed by the consequences that would arise if these rules were applied to DTCs. If the tax authorities of each contracting state interpreted a provision of a DTC in the light of its own domestic anti-abuse rules, it would lead to two different interpretations of the provision because anti-abuse rules differ from country to country. This is not in line with the scheme and purpose of DTCs. Thus, in addition to the above systematic arguments, teleological reasons oppose the application of domestic anti-abuse rules to DTCs.

139 ***Example:*** *The taxpayer was a company resident in the Netherlands, whose shares were owned by an individual resident in Belgium. The individual also held shares in a second company, C NV, which was also resident in the Netherlands. If the taxpayer were to have distributed dividends to the individual, Dutch withholding tax of 25% would have applied. This rate would be reduced to 15% under Art. 10 of the Belgium–Netherlands DTC. The individual instead sold the shares of the taxpayer to C NV in return for cash and the assumption by C NV of a debt owed by the individual to the taxpayer. The taxpayer then distributed the dividends to C NV. Dutch withholding tax did not apply since both companies were residents of the Netherlands. C NV then paid off the debt to the taxpayer. The tax authorities were of the view that the sale of the shares in combination with the dividend distribution and payment of the debt were carried out in order to avoid the Dutch withholding tax on dividends. They relied on the abuse of law doctrine to recharacterize the dividend distribution to C NV as a dividend distribution to the Belgian resident and imposed a 15% withholding tax on this distribution. However, the Supreme Court of the Netherlands allowed the taxpayer's appeal. It acknowledged that Art. 10 of the Belgium–Netherlands DTC allows the Netherlands to levy dividend withholding tax on dividends distributed by a Dutch company to a resident of Belgium, but stated that there was nothing in the DTC that allowed a dividend distribution by a Dutch resident to another Dutch resident to be recharacterized as a dividend distribution by a Dutch resident to a Belgian resident. Art. 10 of the Belgium–Netherlands DTC therefore did not permit the dividend to be taxed as though it had been paid to a Belgian resident (NL, HR 6 Dec. 2002, Case 36.773).*

3. The application of abuse rules of international law?

140 DTCs are part of the domestic law of the contracting states. They are also part of international law as international law treaties (cf. m.no. 21). Scholars have tried to determine the extent to which the denial of treaty benefits in "abuse cases" can be supported by principles of international law. Vogel (*StuW* 1985, 376) came to the conclusion that **international law contains a prohibition** against abuse of law. Namely, the principle of good faith in relationships between states prevents a contracting state from interpreting law unfairly in its favour. In addition, most

states recognize the possibility of considering the "substance" over the "form", if the result would otherwise be contrary to principles of justice. The principle of good faith is binding on states and consequently can be relied upon by the citizens. Therefore, treaty benefits can be denied in cases of abuse.

141 Many national legal systems also prohibit abuse of law in **different forms**. They usually rely on specific anti-abuse rules, from which, however, a **general prohibition against abuse of law** cannot be derived. The policy considerations underlying those specific anti-abuse rules are unequivocally subordinate to international law and in particular to international law treaties. Therefore, in order to restrict tax treaty law, the specific anti-abuse rules would have to be at least on the same level as international law treaties.

142 When a general principle of abuse of law exists in a national legal system, it cannot restrict tax treaty law as well. General principles of law are norms of international law on international law subjects. According to international law scholars, human beings can be international law subjects only in exceptions. In the area of DTCs, however, human beings are not international law subjects. Therefore, a general principle of law **cannot be binding on taxable persons** (cf. Gassner/Lang, in Gassner/Lang/Lechner (eds.), *Entwicklungen*, 58).

4. The importance of statements by the OECD Committee on Fiscal Affairs in the Commentary

143 The Commentary by the OECD Committee on Fiscal Affairs is sometimes used as a legal basis for the denial of tax treaty benefits in cases of abuse. In the interpretation of a particular DTC, reference is generally made to the version of the Commentary in existence at the time of the conclusion of the DTC (cf. m.no. 94). However, the **Commentary on the 1963 OECD Model** does not deal with matters of abuse. Therefore, in my view, tax treaty benefits under DTCs patterned after the 1963 OECD Model may not be denied by describing a certain situation as abuse.

144 In the 1977 update of the Commentary by the OECD Committee on Fiscal Affairs, it was held that the extension of the network of DTCs reinforces the impact of abuse because DTCs enable persons, through the creation of artificial legal constructions, to benefit both from the tax advantages available under certain domestic laws and the relief from tax provided for in DTCs. From these and further considerations, the OECD Committee on Fiscal Affairs concluded, in the Commentary on Art. 1: "It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention." Consequently, treaty benefits cannot be denied in those cases that qualify as an improper use of a convention, if the parties have not so agreed during negotiations. DTC abuse can only be addressed through specific rules in the DTC. Therefore, under DTCs patterned

after the 1977 OECD Model that do not contain rules that deviate from the OECD Model, treaty benefits may **not be denied** by making reference to the Commentary of the OECD Committee on Fiscal Affairs.

145 In 1992, the OECD Committee on Fiscal Affairs supplemented the Commentary. The above-mentioned statement was retained. Further considerations, however, were inserted with respect to the issue of whether the domestic law of the contracting states can be applied at the level of the treaty rights and whether a refusal of the treaty benefits may occur this way: "The large majority of OECD Member Countries consider that such measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them." Domestic anti-abuse rules can therefore be applied on the level of treaty law according to the opinion of the majority of the members of the OECD Committee on Fiscal Affairs (Wurm, *Intertax* 1992, 668). The Commentary on Art. 1 also provided a contrary opinion: "A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use." The OECD Committee on Fiscal Affairs also mentions the reasons for the different opinions: "The main problem seems to be whether or not general principles such as 'substance-over-form' are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions." The minority opinion is set out as follows: "to give domestic rules precedence over treaty rules as to who, for tax purposes, is regarded as the recipient of the income shifted to a base company, would erode the protection of taxpayers against double taxation (e.g. where, by applying these rules, base company income is taxed in the country of the shareholders even though there is no PE of the base company there). However, it is the view of the wide majority that such rules, and their underlying principles, do not have to be confirmed in the text of the convention to be applicable." Very little can be derived from these remarks in the interpretation of DTCs patterned after the 1992 OECD Model: evidently, there were **different opinions** in the OECD Committee on Fiscal Affairs. Hence, treaty benefits may not be denied by reference to the 1992 update of the OECD Model.

146 Since the **update from 2003**, the Commentary does not contain such different opinions anymore. It is now explicitly stated that "it is also a purpose of tax conventions to prevent tax avoidance and evasion" (OECD Commentary on Art. 1, para. 7). The OECD Member countries follow two different approaches regarding the abuse of tax treaties: many countries categorize treaty abuse as an abuse of domestic law because, ultimately, it is a domestic provision that creates tax liability (para. 9.2). Other states view treaty abuse as an abuse of the tax convention itself (para. 9.3). Under both approaches, the OECD Commentary takes the view that a country does not have to grant the benefits of a DTC where abusive arrangements have been entered into (para. 9.4). However, this position has no relevance

for the interpretation of DTCs concluded before 2003. Even for more recent treaties the value of these remarks is limited, since the wording of the OECD Model has not been changed in 2003.

5. DTC evasion as a problem of interpretation

147 Conclusively, in tax treaty law, neither domestic nor international law abuse principles can be applied. However, the Commentary of the OECD Committee on Fiscal Affairs can be used in order to deny tax treaty benefits. Therefore, the relevance of evasion in tax treaty law is exclusively a problem of interpretation. Tax treaty benefits can thus be denied only when the **interpretation of treaty provisions** provides for this result.

148 ***Example:*** *A company resident in the United Kingdom that held shares in an Austrian private limited company transferred these shares to a related Dutch limited liability company. Later, the Austrian company paid dividends to the Dutch company. Under Austrian domestic law, the dividends were subject to a 25% withholding tax. Under the Austria–Netherlands DTC, however, this rate was reduced to 0%. The tax authorities were of the view that the sole purpose of the share transfer was to claim the benefits under the Austria–Netherlands DTC and denied the Dutch company's request for a refund on the basis of the Austrian anti-abuse provision set forth in Sec. 22 of the Austrian Federal Fiscal Code (BAO). Under Sec. 22, tax liability cannot be circumvented through the use of abusive tax structures and, consequently, tax will be computed on the basis of the legal arrangement that would have been more suitable for the transaction. The tax authorities also argued that this domestic anti-abuse provision applied in the context of DTCs and referred to the OECD Report entitled "International Tax Avoidance and Evasion" in support of this position. The Austrian Administrative Supreme Court (VwGH), however, overruled this decision because the tax authorities did not give evidence of the irregularity of the transaction and because the taxpayer had not been given an opportunity to explain whether there were economic reasons for the transfer. It referred the case back to the Appeal Chamber of the regional finance authority to determine whether the transaction would have made sense from an economic point of view, apart from the tax savings. The question whether a domestic anti-abuse provision was applicable in situations where a DTC applies remained unanswered. The court, however, stated that the authorities shall follow the principles of the attribution of income in order to determine the beneficial owner of the dividend income (AT, VwGH 10 Dec. 1997, 93/13/0185).*

6. Special anti-abuse provisions

149 In the Commentary on Art. 1, the OECD Committee on Fiscal Affairs suggests that OECD Member countries may include **special anti-abuse provisions** in

their bilateral treaties. However, the OECD Committee also affirms that such special anti-abuse provisions "need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases".

150 Under the proposed provisions, for example, there is an **"activity provision"** that denies the application of special anti-abuse provisions "where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations".

151 Furthermore, the Committee proposes an **"amount of tax provision"**, i.e. special anti-abuse provisions should not apply "where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident".

152 In addition, the OECD Commentary on Art. 1 contains a **"stock exchange provision"**. It is suggested that OECD Member countries include a regulation in DTCs under which special anti-abuse provisions "shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned – directly or through one or more companies each of which is a resident of the first-mentioned State – by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered".

153 Another proposed rule is known as the **"alternative relief provision"**, which reads as follows: "In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such tax conventions provide relief from taxation not less than the relief from taxation claimed under this Convention".

154 The Commentary also suggests a general **"*bona fide* provision"**. According to this provision, specific anti-abuse rules shall not apply "where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention".

VI. The structures and systems of DTCs

1. Applying the convention

155 The structures and systems of **all DTCs show similarities**. Tax treaties usually contain rules relating to personal and substantive scope. The allocation of taxing rights over the persons and taxes covered is dealt with in one of the allocation rules. The avoidance of double taxation is almost always dealt with in the method article. Other provisions supplement the treaties.

156 Insofar as the treaty follows the OECD Model, the **personal scope** of a DTC is established by Art. 1 and Art. 4 (m.no. 181 et seq.). Under Art. 1 OECD Model, the convention is applicable to persons who are residents of one or both contracting states. Under Art. 4(1) OECD Model, 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, is considered a "resident of a Contracting State". Persons who are liable to tax in that state in respect only of income from sources in that state or capital situated therein are not considered "residents of a Contracting State". It is inferred from this article that full tax liability in one of the two states is a condition for the application of the DTC.

157 The **substantive scope** is established by Art. 2 (m.no. 222 et seq.). Art. 2(1) OECD Model states that the convention shall apply to taxes on income and on capital imposed on behalf of a contracting state or of its political subdivisions or local authorities, irrespective of the manner in which they are levied. Usually, Art. 2 also lists the taxes in force at the time the treaty is concluded, which fall into the substantive scope of the treaty, and establishes that the convention is applicable to any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes.

158 If the convention is applicable to both the person and the taxes, the **allocation rules** must be applied (m.no. 230 et seq.). With respect to the taxation of income, the allocation rules can be found in Art. 6 to Art. 21 OECD Model (with the exceptions of Art. 9). With respect to the taxation of capital, the allocation rules are set out in Art. 22 OECD Model. The legal consequences of the allocation rules differ: some allocation rules reduce source taxation; others entirely remove the taxing rights of the source state. The restriction of taxing rights of the residence state is not generally found in an allocation rule but rather in the method article.

159 The **method article** (Art. 23 OECD Model) contained in DTCs provides the manner in which double taxation will be eliminated (m.no. 398 et seq.): either the exemption method or the credit method will be applied. The exemption method interferes with the taxable base, so that certain income or assets become tax-exempt. The credit method obliges the residence state to credit the taxes levied by the source state in accordance with the allocation rules.

2. Persons covered

160 DTC provisions that reproduce Art. 1 and Art. 4 OECD Model cause the DTC to be applicable if **full tax liability** exists in at least one of the two states. Consequently, the law of the contracting states is decisive in this respect. In the case of full tax liability in one of the two states, the other contracting state is obliged to apply the DTC.

161 DTCs are applicable even if full tax liability exists in both states. In this case, a choice between the two contracting states must be made in order to determine the residence state for tax treaty purposes, since the functioning of the allocation rules and the method article requires that there **only be one residence state**. Insofar as individuals are concerned, the criteria under which the residence state is established are found in Art. 4(2) OECD Model (m.no. 206 et seq.). Permanent home, centre of vital interests, habitual abode and nationality arise in sequence. As far as companies are concerned, the criterion to determine the residence state is found in Art. 4(3) OECD Model (m.no. 220 et seq.). The place of effective management is decisive. In the **UN Model**, apart from the place of effective management, the place of incorporation is mentioned as an additional criterion in Art. 4(1). However, in accordance with the OECD Model, Art. 4(3) UN Model states that ultimately the place of effective management shall be decisive for determining the residence state.

162 The determination of the residence state is **for treaty purposes only**. The residence in just one of the two states does not automatically mean that in the other state taxes are levied under the limited tax liability rules. Domestic full tax liability rules of the source state remain applicable. The amount of tax is determined according to the full tax liability rules and not according to the limited tax liability rules.

163 The DTC signed between two states, however, is not applicable in cases of **limited tax liability in both states**. In these cases, a taxable person can only rely on DTCs potentially existing between the states in which he/she/it is subject to limited taxation and the state where he/she/it is subject to full tax liability. If such DTCs do not exist, double taxation can only be avoided by unilateral measures.

164 ***Example:*** *An individual is resident in Switzerland. She receives dividends from a corporation incorporated in France with its place of effective management in Germany. Both Germany and France tax the dividends paid to the individual. However, the France–Germany DTC does not apply since the individual is subject only to limited tax liability in both states. Double taxation can only be avoided by the application of the France–Switzerland DTC and the Germany–Switzerland DTC.*

3. Taxes covered

165 Pursuant to DTC provisions that reproduce Art. 2(1) OECD Model, the treaty is applicable with respect to **taxes on income** imposed on behalf of a contracting

state or its political subdivisions or local authorities. The manner in which they are levied is irrelevant. In general, taxes imposed on total income or on elements of income are covered. In addition, Art. 2 OECD Model sets out a list of the taxes in force at the time the treaty was concluded to which the DTC shall apply. An adjustment clause usually supplements this provision. Pursuant to this clause, the OECD Model is also applicable to any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes.

166 Pursuant to DTC provisions patterned after Art. 2 OECD Model, the treaty is also applicable to **taxes on capital** imposed on behalf of a contracting state or its political subdivisions or local authorities. As with taxes on income, the manner in which taxes on capital are levied is irrelevant. In general, taxes imposed on total capital or on elements of capital are covered. When taxes on capital are included in the substantive scope of a DTC, the treaty can still have an impact when capital taxes have been abolished in the domestic law of one of the contracting states: as long as the other contracting state keeps levying taxes on capital, the treaty benefits are available to taxable persons despite the fact that the former state has waived levying taxes of that kind.

4. Allocation rules

167 The allocation rules of DTCs (patterned after Art. 6 to 8 and 10 to 21 and Art. 22 OECD Model) shall apply only if the personal and substantive scope of the treaty are fulfilled. Thus, the personal and substantive scope must first be examined. In most cases, the allocation rules do **not ensure that double taxation is avoided**. The limitation of the taxing rights of the residence state is provided for in the method article.

168 ***Example:*** *Pursuant to Art. 7(1) of the Italy–Spain DTC, business profits of an enterprise of a contracting state are taxable in the other contracting state if the enterprise carries on business in that other state through a PE. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to that PE. The profits that an Italian company makes through its PE in Spain can therefore be taxed in Spain. This does not mean, however, that Italy cannot tax these business profits. Art. 7(1) does not address Italy's right to tax. The method article (Art. 22 Italy–Spain DTC) does not deprive Italy of its right to tax but rather provides that Italy will credit the tax paid to Spain on the business profits.*

169 The allocation rules impose **limitations on the taxing rights of the source state**. This is frequently the case with dividends, interest and royalties. The allocation rules often state that the source state's tax cannot exceed a certain rate. The avoidance of the remaining double taxation is dealt with in the method article.

170 ***Example:*** *Under Art. 10(1) of the Australia–Japan DTC, dividends paid by a company that is a resident of a contracting state to a resident of the other*

contracting state may be taxed in that other contracting state. Australia may therefore tax dividends received by an Australian resident from a Japanese company. Japan's taxing right is not restricted by this provision. Art. 10(2) Australia–Japan DTC provides that the dividends may also be taxed in the contracting state of which the company paying the dividends is a resident but the tax cannot exceed 10% of the gross amount of the dividends. Thus, Japan's right to tax is restricted to 10%. The double taxation of this 10% is avoided through the method article (Art. 25 Australia–Japan DTC), which provides that Australia will give a credit for the tax paid to Japan.

171 In some cases, however, the allocation rule **excludes the taxing rights** of one of the two states entirely. This is usually the case when the allocation rules state that certain earnings "shall be taxable only" in the other state. In this case, the former state no longer has any taxing rights.

172 ***Example:*** *Pursuant to Art. 9 of the Belarus–Denmark DTC (interest article), interest arising in a contracting state and paid to a resident of the other contracting state shall be taxable only in that other state. Thus, interest arising in Denmark and paid to a resident of Belarus can only be taxed in Belarus.*

173 All items of income are to be assigned to one single allocation rule. In cases in which none of the allocation rules established in Art. 6 to Art. 20 OECD Model applies, the **blanket clause** in Art. 21 OECD Model (other income) is applicable: all items of income not dealt with in the foregoing articles of the DTC are covered by this clause. Art. 22(4) OECD Model regarding taxes on capital has a similar function. Nearly all DTCs include such other income provisions as foreseen by the OECD Model. However, the treaty network of Jersey (consisting of four DTCs which are in force – with Denmark, Guernsey, Norway and the United Kingdom – and of 10 DTCs not yet in force – with Australia, Faroe Islands, Finland, Germany, Greenland, Iceland, Ireland, Malta, New Zealand and Sweden) shows that these provisions are not necessarily to be found in a DTC: only the treaty signed with Malta (not yet in force) includes a blanket clause along the lines of Art. 21 OECD Model. This will result in situations where double taxation arises because not all sources of income are covered by the allocation rules. Still, this type of convention remains an exception.

174 ***Example:*** *Dividends are covered by Art. 10 OECD Model. The provision applies only to dividends arising in a contracting state and paid to an individual resident in the other contracting state. Thus, dividends received by that resident of Belgium from a company resident in Belgium or in a third country are not covered by Art. 10 OECD Model. In such a case, Art. 21 OECD Model applies. This rule gives the exclusive right to tax to the residence state.*

175 Each item of income or element of capital can **only be covered by one** allocation rule, not by several. The application of the method article presupposes that only one allocation rule is applicable. Should two or more allocation rules receive consideration, it is essential to clarify through interpretation which allocation

rule is to be applied. In some cases the allocation rules contain express priority provisions. These treaty provisions state which allocation rule is to be given priority in the conflict.

176 ***Example:*** *A Dutch company receives dividends from Iceland. Under Art. 7 of the Iceland–Netherlands DTC, the profits of the Dutch company cannot be taxed by Iceland unless the Dutch company has a PE in Iceland. Dividends, however, are covered by Art. 10. Art. 7(7) of the applicable treaty provides that where profits include items of income which are dealt with separately in other articles, the provisions of those articles shall not be affected by the provisions of Art. 7. Thus, Art. 7 provides that Art. 10 Iceland–Netherlands DTC is to be given priority and Iceland will be entitled to tax the dividends.*

5. Methods for elimination of double taxation

177 Generally, in the allocation rules, the taxing rights of one of the two contracting states is partially restricted. Therefore, the manner in which double taxation is avoided is set out in the method article. In continental Europe, the **exemption method** is often adopted: the residence state excludes from the taxable base the income derived or the capital owned in the other state. In this case, the taxing rights lie only with the source state. The residence state may nevertheless take the exempt income or capital into account in calculating the amount of tax on the remaining income or capital of the taxable person. The proviso safeguarding progression should ensure the mitigation of the advantages created through both, the allocation of income to the source state and the classification of income into low-tax brackets in both states.

178 ***Example:*** *A Hungarian entrepreneur has a place of business in Budapest and another in Munich. In each place of business, he earns business profits of EUR 50,000. Pursuant to Art. 7(1) of the Germany–Hungary DTC, the business profits earned in Munich can be taxed by Germany. Art. 23(2)(a) of that DTC precludes Hungary's right to tax these profits, but Art. 23(2)(a) Germany–Hungary DTC allows these profits to be taken into account in determining the tax due on the remaining income. Consequently, only the income of EUR 50,000 in Hungary is subject to tax in this state but the applicable rate of tax is the one that would be applied to income of EUR 100,000.*

179 The second method is the **credit method**. It is especially common for countries belonging to the Anglo-American legal system. It is also adopted in almost all DTCs to avoid double taxation on dividends and interest and, in some DTCs, to avoid double taxation on royalties. Under the credit method, the taxable base in the residence state remains unchanged. In other words, the foreign income is still included in the domestic taxable base. However, the taxes levied in the source state are credited on the taxes levied in the residence state.

180 ***Example:*** *A Maltese corporation receives dividends of EUR 10,000 from a 5% holding in an Irish corporation. Pursuant to Art. 10(1) Ireland–Malta*

DTC, Malta may tax these dividends. Under Art. 10(2), Ireland may also tax the dividends to a maximum of 15%. Under Art. 22(2), Malta will give a credit for Irish tax at source. In Malta, the EUR 10,000 are subject to corporate tax of 35%, and tax of EUR 3,500 is payable. The Irish tax at source amounts to EUR 1,500, which is credited on the Maltese tax due such that it amounts to EUR 2,000.

VII. Persons covered

1. Full tax liability as a prerequisite for the application of the DTCs

1.1 Full tax liability

181 Pursuant to treaty provisions patterned after Art. 1 OECD Model, DTCs are applicable to persons who are residents of one or both contracting states. Art. 4 OECD Model serves as a basis for treaty provisions defining the **concept of residence**. Under these provisions, a resident is "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. 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." In practice, this wording indicates that full tax liability in one of the two contracting states leads to treaty entitlement.

182 ***Example:*** *A corporation is established in the Netherlands and is subject to full tax liability therein. It derives income almost exclusively from Dutch sources but it also holds a 7% participation in a French company from which it receives dividends. With respect to those dividends, the Dutch company benefits from the EC participation exemption regime, according to which the dividends are fully excluded from the taxable base. Therefore, the Dutch company is subject to taxation only on Dutch source income. Nevertheless, the Dutch company is a resident of the Netherlands under the DTC between France and the Netherlands so that the DTC is applicable. In fact, full tax liability in the Netherlands is sufficient for these purposes. Therefore, the Dutch company can also benefit from the reduction of French taxation at source on the dividends according to the provisions on dividends included in the DTC between France and the Netherlands.*

183 Any taxable person who is liable to tax in one of the two contracting states by reason of his domicile, residence, place of management "or any **other criterion of a similar nature**" is entitled to treaty benefits. The meaning to be attributed to "similar" is controversial. According to one opinion, every characteristic which leads to full tax liability is similar (cf. Huemer, *Steuerpflicht*, 99 with further references). According to another, the characteristics mentioned in Art. 4(1) OECD Model are of a locality-related nature; hence, it is crucial that the "criterion of a similar nature" also be a locality-related criterion (Vogel, *DTC* Art. 4, m.no. 29).

184 ***Example:*** *In some countries, such as the United States, nationality attracts full tax liability. In other countries, persons are deemed to be residents by other criteria, even though they have no physical home or location in the state. In some DTCs, these additional criteria are included in Art. 4(1) (Vogel,*

DTC Art. 4, m.no. 30). If the DTC does not include the additional criteria, deemed residents of the state who are resident in third countries may or may not be entitled to treaty benefits of DTCs concluded by that state. If a court believes that "other criterion of a similar nature" refers only to characteristics of a locality-related nature, a deemed resident of the state who is resident in State A will not be entitled to benefits of DTCs concluded between State A and State B. If, on the other hand, the court is of the view that the phrase refers to every characteristic which leads to full tax liability, the deemed resident will be entitled to benefits of the DTC concluded between State A and State B.

1.2 Effects of the DTC non-discrimination rules

185 According to some opinions, the non-discrimination rules usually included in DTCs can lead to treaty entitlement of persons who are not residents of a contracting state (cf. e.g. Jirousek, *ÖStZ* 1999, 607). In particular, the **non-discrimination rules regarding PEs** through which non-residents carry on their activities are sometimes interpreted as allowing these non-residents tax treaty benefits in the PE state under DTCs concluded between the PE state and other states. However, the OECD Commentary on Art. 24 (at para. 69 et seq.) takes a different view: a PE of a company that is not resident in one of the contracting states and which receives e.g. dividend payments arising in a contracting state, shall therefore not be granted treaty benefits (and not be given a tax credit). Double taxation arising from this situation can be avoided by domestic provisions or supplementary DTC rules, which are bilaterally negotiated.

186 ***Example:*** *A company resident in Switzerland has a PE in France. Interest from Hungarian sources is attributable to this PE. The France–Hungary DTC is inapplicable since the company is not a resident of either contracting state. However, Art. 26(3) of the France–Switzerland DTC (non-discrimination) provides that the taxation of a PE, which an enterprise from Switzerland has in France, shall not be less favourably treated in France than the taxation levied on enterprises of France carrying on the same activities. According to the view mentioned above, France must treat the PE of the Swiss company no less favourably than it would treat PEs of French enterprises. In taxing the business profits of the PE, France must therefore allow the PE a credit for the tax paid to Hungary.*

1.3 Effects of other DTCs

187 Under international law, the relationship between third states and treaties is defined by the general formula *pacta tertiis nec nocent nec prosunt*: a treaty only creates law between states which are parties to it; neither rights nor obligations can be created by it with regard to third states. This general principle is codified in **Art. 34 VCLT**.

188 Nevertheless, the applicability of a certain DTC might be influenced by a DTC concluded by one contracting state with another state. This might occur **because of the residence tiebreaker rules** which are contained in the latter DTC (cf. e.g. the IRS Revenue Ruling 2004-76). Grounds for this interpretation are found in the second sentence of Art. 4(1) OECD Model, according to which 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 or capital situated therein". In fact, due to the 2008 amendments to the OECD Model, the Commentary on Art. 4 OECD Model (at para. 8.2) now reads as follows: "According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State … companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States". Such an interpretation, however, is questionable from a legal standpoint (cf. also Vann, in Maisto (ed.), *Residence of Companies*, 252 et seq.)

189 ***Example:*** *A company is incorporated under the law of State A and has its place of effective management in State B ("Company AB"). Company AB is a resident of both states under domestic law. The company owns a 51% participation in a company which is a resident of State C ("Company C"). There is no DTC between State B and State C, while OECD-patterned DTCs exist between State A and State C and State A and State B. Under State C's domestic law, a 30% withholding tax applies to outbound dividends. In 2010, dividends are paid by Company C to Company AB. State C does not grant a reduction in withholding tax as set out in the A–C DTC (5%). According to State C, Company AB cannot claim the benefits of the A–C DTC since it is not a resident of State A under Art. 4(1) of the A–C DTC. This would be due to the fact that, notwithstanding that Company AB is a resident of State A under domestic law, it is not considered to be a resident of State A under the A–B DTC. This conclusion, however, is questionable from a legal standpoint.*

2. Treaty entitlement of corporate entities that are subject to limited tax liability

2.1 Public law corporations

190 It has occasionally been questioned whether public law corporations that are **subject to limited tax liability** are entitled to treaty benefits. Vogel correctly points out that the condition for tax treaty entitlement is not that the person be actually taxed without restriction but that the person merely shows those connections to the contracting state that can lead to full tax liability (Vogel, *DTC* Art. 4, m.no. 24 et seq.). Therefore, states and their political subdivisions or local authorities are also entitled to treaty benefits.

191 ***Example:*** *An Austrian municipality holds shares in a Swiss corporation. The dividends received from this participation are not received in connection with a business carried on by the municipality. The Austrian municipality is nevertheless entitled to the 15% withholding tax rate provided by Art. 10(2) of the Austria–Switzerland DTC.*

192 In 1995, the OECD Committee on Fiscal Affairs changed Art. 4(1) OECD Model in this respect, expressly including states and their political subdivisions or local authorities among persons entitled to treaty benefits. It is doubtful, however, whether **public law corporations** that are **not at the same time political subdivisions** or local authorities are entitled to treaty benefits. Since the OECD Committee on Fiscal Affairs merely mentioned states and their political subdivisions or local authorities, it could be argued that the reverse conclusion is applicable to public law corporations, i.e. that public law corporations do not have any tax treaty entitlement. However, the intention of the OECD Committee on Fiscal Affairs was obviously not to go in this direction and such reverse conclusion shall not be drawn.

193 ***Example:*** *The Austrian students' union is a public law corporation. It receives interest payments from Italy. These payments are taxable in Austria under Austrian domestic law notwithstanding the fact that the Austrian students' union is generally subject to limited tax liability in Austria. The Italian tax at source is reduced to 10% pursuant to Art. 11(2) of the DTC between Austria and Italy and is credited against Austrian tax under the same treaty. In my opinion, despite the 1995 amendments to the OECD Model, this conclusion is still correct.*

2.2 Corporate entities that are exempt from full tax liability

194 Corporate entities that are exempt from full tax liability are also **regarded as being entitled** to tax treaty benefits. The same considerations that apply to public law corporations apply to these corporations. The fact that these exempt corporations are not expressly mentioned in Art. 4(1) OECD Model, in contrast to states and their political subdivisions or local authorities, does not alter this conclusion.

195 ***Example:*** *In SE, Regeringsrätten 2 Oct. 1996, RÅ 1996 ref 84 (6301-1994), a Swedish company held a 100% share in a Luxembourg fund. Under Luxembourg law, the fund was exempt from corporate tax and any other tax covered by the Luxembourg–Sweden DTC. When the fund distributed profits to the parent company in Sweden, the question was whether the DTC was applicable. In particular, was the fund resident in terms of Art. 4(1) of the Luxembourg–Sweden DTC and were the dividend payments therefore covered by Art. 10 of the treaty? The Swedish Supreme Administrative Court held that the DTC was applicable to the situation at hand. The Court interpreted the phrase "liable to tax", which is a prerequisite for being resident in terms of Art. 4(1), as a requirement of formally being subject to unlimited tax liability. It was not*

necessary that the person actually has paid tax. Consequently, when the profits of the funds were distributed as dividends, the domestic exemption provisions and Art. 22(2)(b) of the Luxembourg–Sweden DTC applied and the result was double non-taxation.

3. Treaty entitlement of partnerships and/or partners

196 Partnerships are "persons". Under Art. 3(1)(a) OECD Model, the term "**person**" includes individuals, companies and any other body of persons. Under Art. 3(1)(b) OECD Model, the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes. In order to be entitled to tax treaty benefits, a person must also be a resident of one or both of the two contracting states under Art. 4(1) OECD Model. Accordingly, a person has to be "liable to tax". Thus, liability to tax in one of the two contracting states is a condition of treaty entitlement.

197 According to prevailing opinion, partnerships are not entitled to tax treaty benefits if they are not tax subjects for income tax purposes. The application of the tax treaty is therefore obtained "through" partnerships. Consequently, the person **entitled to tax treaty benefits** is not the partnership but **rather the partner(s)**.

198 ***Example:*** *An Italian partnership has three partners and a place of business in Spain. One partner is resident in Germany, another in Switzerland and the third in Italy. With respect to the Italian partner's income, the Italy–Spain DTC applies; with respect to the Swiss partner's income, the Spain–Switzerland DTC applies; with respect to the German partner's income, the Germany–Spain DTC applies.*

199 The above conclusion, however, is controversial if a partnership is **characterized in different ways** in two states, e.g. if it is characterized as a taxable entity in one state and is treated as transparent for tax purposes in the other state. The OECD Committee on Fiscal Affairs created a Working Party that produced a report on this topic. The OECD's position makes the tax treaty entitlement in the source state dependent on the tax treatment of the partnership in the state in which it is established: if the partnership is treated as a tax subject in the latter state, it should be entitled to treaty benefits, otherwise the partners should be entitled to tax treaty benefits if they are resident there (cf. Lang, *Partnerships*). However, more convincing arguments suggest the focus should be put on the tax treatment in the source state. Therefore, partnerships which are characterized as taxable persons by the source state should also be entitled to tax treaty benefits there. If they show close connections to a state that is a DTC partner, which would normally lead to full tax liability, the relevant DTC should be applicable.

200 ***Example:*** *A partnership with a head office in State P receives dividends from a company resident in State S. The partners of the partnership are resident in State R. States S and R treat the partnership as a taxable entity while State P*

treats it as transparent. According to the opinion set out in the OECD Partnership Report, the P–S DTC is not applicable because the partnership is not a resident of State P since State P treats it as transparent. The partners are resident in State R but since State R considers the income to be earned by the partnership and not the partners, the R–S DTC cannot apply. The tax in State S is therefore not restricted since neither DTC applies. If, however, the characterization in the source state were followed, the P–S DTC could apply. Admittedly, the partnership is not resident in State P; however, the necessary connection for purposes of residency (head office) exists in P.

201 Some DTCs contain **special provisions** for partnerships. These DTCs set out the conditions under which the partner(s) are entitled to tax treaty benefits. For example, many DTCs concluded by the United States include a provision which codifies the OECD approach. Under that provision: "An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident". Moreover, in some DTCs, it is sometimes stated that, under certain conditions, partnerships are entitled to tax treaty benefits. For example, under Art. 28(6) of the DTC between Austria and Switzerland, partnerships (general partnerships, collective companies, limited partnerships), which are established under the law of a contracting state and which have their seat in that state, "may claim the tax relief, granted in Articles 10, 11 and 12 of the Convention, from the other State, provided that at least three quarters of the profit of the association is benefiting persons who are residents of the first-mentioned State". In recent tax treaties concluded by the Netherlands, the Protocol of the treaty contains a provision with respect to hybrid entities, which may in some cases include partnerships. The provision reads as follows: "In case an entity that is treated as a body corporate for tax purposes is liable as such to tax in a Contracting State, but the income of that entity is taxed in the other Contracting State as income of the participants in that entity, the competent authorities shall take such measures that on the one hand no double taxation remains, but on the other hand it is prevented that, merely as a result of application of the Convention, income is (partly) not subject to tax." This provision allows the competent authorities of the Contracting States to formulate customized solutions on a case-by-case basis.

4. Treaty entitlement and treaty abuse

202 DTCs patterned after the OECD Model grant all persons that are residents of one of the two contracting states tax treaty benefits. Treaty entitlement depends only on the **residence status**. Further restrictions are not found in DTCs which are patterned after the OECD Model. Nevertheless, tax authorities are inclined to hold that tax treaty entitlement is not to be granted in cases, in which **domestic**

anti-abuse provisions apply (cf. m.no. 134 et seq.), or because of an **unwritten international principle of international law preventing abuse** (cf. m.no. 140 et seq.). In my opinion, however, no legal basis exists for such conclusions.

203 ***Example:*** *A Tunisian corporation receives dividends from a Norwegian corporation. Pursuant to Art. 10(1) of the Norway–Tunisian DTC, the Norwegian withholding tax rate is decreased from 25% to 20%. As long as these dividends are attributable to the Tunisian corporation, the DTC applies, even when the shareholders of the Tunisian corporation are not resident in Tunisia, but in countries with which Norway has not concluded any DTC, and therefore could not benefit from a reduction in withholding taxes. There is no legal basis for not applying the DTC.*

204 However, in some DTCs, there are **express rules** that provide that abuse is a basis for the denial of tax treaty entitlement. These rules allow contracting states to deny tax treaty benefits in those cases in which the entitlement to tax treaty benefits is regarded as undesirable.

205 ***Example:*** *A Luxembourg holding, exempt under the special Luxembourg law from 1929, receives dividends from Canada. The reduction in withholding tax provided by Art. 10(2) of the Canada–Luxembourg DTC does not apply because according to Art. 28(3) the treaty is not applicable to the Luxembourg holding.*

5. Residence state in the case of dual residence

5.1 Necessity of determining the residence state

5.1.1 Allocation rules

206 DTCs use the concept of "residence" for different purposes. Under Art. 1 and Art. 4(1) OECD Model, residence is a condition for the application of the tax treaty. Persons who are residents of one or both of the contracting states are regarded as being entitled to treaty benefits. For the purposes of these provisions, a person can be a resident of both contracting states. In other words, it is not necessary to award one of the two states the priority of rank.

207 Things are different under the allocation rules of DTCs. These rules presuppose that only one of the two states is the residence state. If both states under Art. 1 and Art. 4(1) OECD Model are regarded as residence states, a rule must exist to **determine** which state is the **residence state** in order for the allocation rules to apply properly.

208 ***Example:*** *An individual, who is resident both of Finland and of Switzerland, receives dividends from sources in Switzerland. Pursuant to Art. 10(2) of the Finland–Switzerland DTC, the tax at source is restricted to 10%. However, the application of Art. 10 of that DTC requires that the company paying the dividends and the person receiving the dividends are residents of different contracting states. In other words, Art. 10 Finland–Switzerland DTC applies*

only if the application of the tiebreaker rules of Art. 4(2) of the Finland–Switzerland DTC leads to the recipient of the dividends being a resident of Finland (for the tiebreaker rules cf. in detail m.no. 211).

5.1.2 Method article

209 The same arguments apply for the purposes of the method article. This article applies to persons who are residents of a contracting state and derive income that may be taxed in the other contracting state. The differentiation from "a" and "the other" contracting state requires that **only one of the two states be the residence state**. Otherwise, the application of the tax treaty fails.

210 ***Example:*** *A corporation incorporated in Greece and managed in Romania receives royalties from Romania. The corporation is considered a resident of both Greece and Romania under the applicable domestic laws. Under Art. 25 of the Greece–Romania DTC (method article), the state of residence of the recipient of the royalties must grant a deduction from tax on income with respect to tax paid in the other contracting state. If Art. 25 of the DTC were applied on the basis of the domestic definition of residence, Greece would be bound to grant such a deduction for the taxes paid in Romania. However, under Art. 4(3) of the DTC, the corporation is deemed to be a resident of Romania since its place of effective management is in Romania. Since Greece is not the state of residence of the corporation under the DTC, it is not required to grant a deduction for tax paid with respect to the royalties earned in Romania.*

5.2 Criteria

5.2.1 Permanent home

211 A DTC provision patterned after Art. 4(2) OECD Model provides a list of criteria for establishing, as far as individuals are concerned, how "residence" is to be determined for the purposes of the allocation rules and of the method article. These provisions are known as **"tiebreaker rules"**. The very first criterion that applies for determining residence for the purposes of the allocation rules and the method article in the case of dual residence is the permanent home. If an individual is a resident of both contracting states under Art. 4(1) he/she is resident, for treaty purposes, only in the state where he/she has a permanent home.

212 ***Example:*** *A citizen of the United States is employed in Mexico and has an apartment there. He does not have a home in the United States. Under US domestic law, he is liable to unlimited taxation in the United States. Under Mexican rules he is liable to unlimited taxation Mexico as well. For the purposes of the Mexico–US DTC, however, he is deemed to be a resident of Mexico since he has a permanent home available to him in Mexico but not in the United States. However, under the saving clause contained in Art. 1(4) Mexico–US DTC, the United States retains its right to tax its citizens as if the treaty had not come into effect. Consequently, the allocation rules do not*

apply. Double taxation is still prevented through Art. 1(5) in connection with Art. 24(4) Mexico–US DTC, which provides special rules for US citizens resident in Mexico.

5.2.2 Centre of vital interests

213 If an individual owns a permanent home in both contracting states, that person will be a resident of the state with which his/her **personal and economic relations** are closer, i.e. the state where his/her centre of vital interests is established. Personal relations will be found in the person's family life as well as in social and religious interests and activities. Economic relations exist with activities linked to a locality or source of income. According to Vogel, priority cannot be given to either personal relations or economic relations because the concept is indivisible. In some countries, however, court decisions give priority to personal relations in cases of doubt (Vogel, *DTC* Art. 4, m.no. 75b; AT, VwGH 25 Feb. 1970, 1001/69; AT, VwGH 22 Mar. 1991, 90/13/0073).

214 ***Example:*** *An individual has homes in both Germany and Canada. The person earns income from sources in both states. The person's spouse and children reside primarily in the German home and the individual's social and cultural activities are centred in Germany. According to a Canadian judgment, the person is a resident of Germany for purposes of the Canada–Germany DTC since his centre of vital interests is in Germany [CA, FCA 18 Aug. 2006, Hertel v. MNR, 93 DTC 721].*

5.2.3 Habitual abode

215 Under certain conditions, the person's habitual abode will be determinative. Under Art. 4(2)(b) OECD Model, this is the case if the state in which the individual has his centre of vital interests cannot be determined or if he/she does not have a permanent home available to him/her in either state. In the literature, the habitual abode is seen to be in the **country in which one "normally lives"** (Vogel, *DTC* Art. 4, m.no. 78); however, the OECD Commentary on Art. 4 appears to put the focus on the state in which the person spends more time.

216 ***Example:*** *The French Cour Administrative d'Appel considered the case of a taxpayer who lived permanently in Ivory Coast where he worked. His wife and children lived in France and he visited France 1 or 2 months per year. Art. 2 of the France–Ivory Coast DTC provided that "an individual shall be deemed to be domiciled in the place in which he has his 'permanent home', that expression being understood to mean the centre of vital interests, i.e. the place with which his personal relations are closest". The Cour Administrative d'Appel stated that it was impossible to determine the place of his permanent home since his family lived in France but he was permanently in Ivory Coast for work. It proceeded to the next test, where he principally resides, and concluded that the taxpayer was a resident of Ivory Coast (FR, CAA 28 Dec. 1995, 94PA01491).*

5.2.4 Nationality

217 According to Art. 4(2)(c) OECD Model, if the individual has a habitual abode in both states or in neither of them, he/she shall be deemed to be a resident only of the state of which he/she is a national. As indicated by Art. 3(1)(g) OECD Model, insofar as individuals are concerned, the term "national" means any individual possessing the **nationality or citizenship of a contracting state**. Thus, nationality or citizenship under domestic law is decisive.

218 ***Example:*** *The French Conseil d'État considered the case of a taxpayer who had permanent homes in both France and Germany. The individual worked in Germany but spent weekends and holidays in France with his family. The centre of vital interests of the taxpayer was equally divided between the two states and the habitual abode could not be determined because of the frequent trips between France and Germany. The Court used the nationality tiebreaker rule to determine that the taxpayer was a resident of France (FR, CE 26 Jan. 1990, 69.853).*

5.2.5 Mutual agreement procedure

219 If the application of the above criteria does not lead to a clear determination, reference must be made to Art. 4(2)(d) OECD Model (mutual agreement procedure): if the individual is a national of both states or of neither of them, the competent authorities of the contracting states shall settle the question by mutual agreement. For the decisions of the authorities, no restrictions exist with respect to the content. In the literature, it has been argued that in this case the competent authorities have an **obligation to reach a mutual agreement** (cf. Vogel, *DTC* Art. 4, m.no. 82). However, there is no indication with respect to how the obligation to reach a mutual agreement could be enforced.

5.2.6 Place of effective management

220 For **legal entities**, only one single criterion is set out in Art. 4(3) OECD Model. If a person other than an individual is a resident of both contracting states, it will be considered a resident of the state where its "place of effective management" is situated. This concept is an autonomous concept in tax treaties. There is extensive consensus among scholars on this conclusion (Vogel, *DTC* Art. 4, m.no. 104). The OECD Model apparently assumes that this **criterion makes a clear decision possible**: no other criterion is set out and there is no reference to the mutual agreement procedure.

221 ***Example:*** *A Maltese company, X Malta Ltd., owned 100% of a Swedish company, X AB. After a reorganization of the business of X AB, this company no longer had an establishment in Sweden and was subject to full tax liability in Malta under Maltese domestic legislation. X AB raised the question before the Swedish Council for Advance Tax Rulings whether, after the reorganization, its place of effective management was in Malta. If so, it would be a resident of*

Malta pursuant to Art. 4(3) of the DTC between Malta and Sweden. In reaching its conclusion, the Swedish Council for Advance Tax Rulings decided that under the domestic laws of Malta and Sweden, X AB was a resident of both Sweden and of Malta. The Council then considered Art. 4(3) DTC Malta–Sweden, which was patterned after the OECD Model and gave relevance to the place of effective management. Since all of X AB's management functions were exercised in Malta, the Swedish Council for Advance Tax Rulings considered that the place of effective management of X AB was located in Malta and, therefore, company X AB was a resident of Malta for treaty purposes. These conclusions were confirmed by the Regeringsrätten (SE, RR 24 Apr. 2008, RÅ 2008 ref 30 (6639-06)).

VIII. Taxes covered

1. Income taxes

The OECD Model covers **taxes on income and on capital**. The manner in which they are levied is irrelevant. The taxes must be imposed on behalf of a contracting state or of its political subdivisions or local authorities (cf. m.no. 190). The OECD Model provides for a general definition of taxes on income: all taxes imposed on total income or on elements of income, including taxes on gains from the alienation of movable or immovable property, as well as taxes on the total amounts of wages or salaries paid by enterprises. **222**

DTCs regularly contain an **exemplary list** of taxes on income to which the treaty is applicable. When DTCs are patterned after the OECD Model, this list is found in Art. 2(3) and is introduced by the following sentence: "The existing taxes to which the Convention shall apply are in particular: …" The use of the term "in particular" clarifies that the list is not exhaustive but merely serves to illustrate the general definition found in Art. 2(1) and (2) OECD Model. **223**

2. Capital taxes

The OECD Model is also applicable to **taxes on capital** that are imposed on behalf of a contracting state or of its political subdivisions or local authorities. As is the case with taxes on income, the manner in which taxes on capital are levied does not play any role. The OECD Model provides for a general definition of taxes on capital. It includes all taxes imposed on total capital or on elements of capital, including taxes on capital appreciation. However, not all DTCs are to be applied to taxes on capital. Some treaties apply only to taxes on income (e.g. all Japanese DTCs). **224**

> ***Example:*** *Art. 2 Albania–China DTC provides a definition of taxes covered by the treaty, including capital taxes (all taxes imposed on total capital or on elements of capital, including taxes on gains from the alienation of movable or immovable property, as well as taxes on capital appreciation). Furthermore, it explicitly lists Albanian property tax as being covered by the treaty and states that substantially similar taxes imposed after having signed the DTC shall also be covered.* **225**

In the area of capital taxes, the taxes in force at the time the treaty was concluded are usually listed in DTCs. It is worth noting that DTCs which also cover capital taxes still apply to those taxes even when one of the countries stops levying them. DTCs may limit the taxing rights of only one contracting state, thus they apply even though only one contracting state levies capital taxes. **226**

3. Comparability

227 The OECD Model and most DTCs contain clauses pursuant to which the treaty shall apply to **any identical or substantially similar taxes** that are imposed after the date of signature in addition to, or in place of, the existing taxes. These clauses seek to prevent situations in which the introduction of new taxes leads to a re-negotiation of a DTC. If the newly introduced taxes are comparable to the taxes existing at the time the treaty was concluded, the treaty is applicable.

228 ***Example:*** *In 2003, a Swiss resident taxpayer disposed of a number of shares in a company incorporated and resident in Australia. Under Art. 7(1) of the Australia–Switzerland DTC, Australia did not have any taxing rights in respect of that gain. Nevertheless, the Australian tax authorities argued that such gain was subject to the Capital Gains Tax (CGT), a tax that was introduced in 1985 after the treaty was concluded (1980). The Australian tax authorities argued that CGT was not covered by treaties concluded before its introduction and Australia was therefore not restricted by the treaty between Australia and Switzerland. The Court noted that CGT was not a separate tax but merely a part of the Australian income tax under the relevant Income Tax Assessment Act and ruled that CGT was "substantially similar, if not identical, to the income tax" for the purposes of Art. 2(2) of the Treaty (AU, FCA 10 Oct. 2008, Virgin Holdings SA v. Federal Commissioner of Taxation, [Similar conclusions were reached in AU, FCA 3 Feb. 2009, Undershaft (No. 1) Ltd. v. Federal Commissioner of Taxation and in IE, HC 31 Jul. 2007, Kinsella v. Revenue Commissioners (cf. m.no. 115)].*

4. Inheritance and gift taxes

229 In addition to the OECD Model on income and on capital, there is an OECD Model in the area of inheritance taxation. This OECD Model was published in 1966 and was modified in 1982 (cf. m.no. 531). Gift taxes have been included in the substantive scope of this OECD Model since 1982. Most DTCs consequently cover income and capital taxes only. However, there are some **"combined" treaties** which also deal with inheritance and gift taxes, e.g. the Sweden–Germany DTC and the Algeria–France DTC.

IX. Allocation rules

1. Income from immovable property

1.1 Immovable property

Income from immovable property is dealt with by treaty provisions patterned after **Art. 6 OECD Model**. The concept of immovable property is set out in Art. 6(2) OECD Model: "The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources". These terms have to be interpreted as far as possible within the context of the OECD Model. **230**

Art. 6 OECD Model covers income arising from the immediate **utilization of the property** and the rental or lease of the property, as well as income arising from any other use of real estate. The general rule applies irrespective of the form of exploitation of the immovable property. However, capital gains deriving from the sale of the immovable property are not covered. Nonetheless, Art. 13(1) OECD Model states that the place where the property in question is situated is also decisive for the allocation of taxing rights on such capital gains. **231**

1.2 Allocation of taxing rights

Pursuant to treaty provisions patterned after **Art. 6(1) OECD Model**, income derived by a resident of a contracting state from immovable property situated in the other contracting state may be taxed in the latter state. Consequently, the state in which the immovable property is situated has the right to tax. Art. 6 OECD Model does not address the taxing rights of the residence state. The question whether the residence state may also tax the income and grant credit for the taxes levied in the source state, or must instead exempt such income, is decided in the method article. **232**

Example: *An individual resident in the Czech Republic rents out real estate situated in Croatia. Under Art. 6 of the Croatia–Czech Republic DTC, Croatia has the right to tax this rental income. Art. 6 does not address the taxation rights of the Czech Republic. Thus, Art. 23 has to be consulted. Under this provision, the Czech Republic must apply the credit method in order to avoid double taxation.* **233**

The allocation rule of Art. 6 OECD Model only comes into effect if the recipient of the income is resident in a contracting state and the immovable property is situated in the other contracting state. Art. 6 is therefore inapplicable if the im- **234**

movable property is in the contracting state of which the recipient of the income is a resident or if the immovable property is situated in a third country.

235 ***Example:*** *An individual resident in Japan receives income from the rental of a Japanese property. Since the residence state of the recipient of the income and the situs state of the property are the same, Art. 6 OECD Model does not apply (all Japanese DTCs, apart from the treaties with Austria, Australia, Fiji and Sri Lanka, follow the OECD Model with respect to that criteria of immovable property). In the absence of other allocation rules, Art. 21 (other income) would apply. This, however, would not change the fact that Japan has the right to tax.*

236 Art. 6(4) OECD Model contains a **priority rule** for cases in which immovable property, from which the income is earned, is used in the exercise of a business or the performance of independent personal services. Where Art. 7 OECD Model or Art. 14 of the former OECD Model are also applicable, the allocation rule regarding immovable property takes precedence and the situs state has the right to tax.

237 ***Example:*** *A Dutch enterprise holds Malaysian real estate in its business property. The income derived from this property could be qualified as income from immovable property and as business income. The provisions of Art. 7(4) of the Malaysia–Netherlands DTC, however, provide that Art. 7 takes precedence (corresponds to Art. 6 OECD Model). Malaysia therefore has the taxing right irrespective of the existence of a PE in Malaysia. According to Art. 23(2) (method article), the Netherlands has to exempt the income derived from Malaysia.*

2. Business profits

2.1 Business profits

238 **Art. 7 OECD Model** regulates business profits and thereby requires the existence of a "business" or an enterprise. This concept is not defined in the OECD Model. Also, the Commentary on Art. 3 indicates that the Model "does not contain an exhaustive definition" – neither of the term "enterprise" (cf. OECD Commentary on Art. 3, para. 4) nor of the term "business" (cf. OECD Commentary on Art. 3, para. 10.2). On the one hand, it is therefore occasionally concluded that it is necessary to refer to domestic law in order to define this term (cf. Avery Jones et al., *Bulletin – Tax Treaty Monitor* 2003, 237 et seq.). On the other hand, it is argued that due to the lack of definition the concept needs to be interpreted within the context of the DTC.

239 In 2000, the OECD Fiscal Committee **deleted Art. 14 OECD Model** without replacing it (cf. also m.no. 322). The OECD Fiscal Committee was of the view that Art. 14 OECD Model has essentially the same legal consequences as Art. 7 OECD Model and is therefore superfluous. Thus, all income formerly covered

under Art. 14 OECD Model should now be assigned to Art. 7 OECD Model. However, it will take a long time for the change in the OECD Model to be implemented in bilateral agreements.

240 For DTCs that still include two separate articles for business income and independent professional services, the following **distinction** can be made: Art. 7 should cover income from independent and lasting activities which do not fall under Art. 14 (for the concept of services, cf. m.no. 323).

2.2 Allocation of taxing rights

241 The profits of an enterprise of a contracting state shall be **taxable only in that state**. According to Art. 7(1) OECD Model, the only exception arises when the enterprise carries on business in the other contracting state through a PE situated therein. In cases in which there is no PE situated in the other state, Art. 7(1) OECD Model gives exclusive taxing rights to the residence state, in which case the method article is not required.

242 ***Example:*** *A Spanish company provides advisory services in Portugal but does not have a PE in Portugal. Under Art. 7(1) Portugal–Spain DTC, Spain has the exclusive taxing right. The method article does not need to be consulted.*

243 If the company carries on business in the other contracting state through a PE situated therein, Art. 7(1) OECD Model provides that the **PE state also has the right to tax**. The PE state may tax the profits but only to the **extent to which they are attributable to that PE**. Art. 7(1) OECD Model does not preclude the residence state from taxing this income.

244 ***Example:*** *A Swedish company has one PE in Norway and one in Denmark. Business profits amounting to SEK 1 million can be attributed to both PEs. According to Art. 7(1) of the Nordic Convention (NC), Norway and Denmark may tax the profits attributable to the PEs situated in their countries. This provision, however, does not remove Sweden's taxing right. The method article (Art. 25 NC) provides for the credit method. Sweden must allow a credit for taxes paid in Norway and in Denmark against the taxes payable in Sweden in order to avoid double taxation.*

245 The general rule that a PE state may only tax profits attributable to the PE is slightly amended in the UN Model: **Art. 7(1)(b) and (c)** provides for the **"limited force of attraction principle"**, which permits that the enterprise, once it carries out business through a PE in the source state, can be taxed on business profits in that state arising from transactions of the same or similar kind outside the PE (Vogel, *DTC* Art. 7, m.no. 35).

246 Art. 7 OECD Model uses the concept of business profits of an **"enterprise of a Contracting State"**. This term is defined in Art. 3(1)(d): it is assumed to be an enterprise that is carried on by a resident of a contracting state. If there is no PE in the other contracting state to which the business profits are attributable, the

residence state of the person who runs the enterprise has the exclusive taxing right with respect to the business profits.

247 ***Example:*** *An individual resident in Estonia runs a grocery store in Riga, Latvia. In terms of treaty law, this activity is an Estonian enterprise because it is run by an Estonian resident (Art. 3(1)(f) Estonia–Latvia DTC). The grocery store, however, constitutes a Latvian PE and, consequently, Latvia may tax the income attributable to the PE (Art. 7 and Art. 5 Estonia–Latvia DTC).*

248 The concept of PE is important for the allocation of taxing rights. With respect to the concept used in the OECD Model, only the definition contained in Art. 5 OECD Model is decisive. A PE must be a **fixed place of business** through which the business of the enterprise is wholly or partly carried on. The requirement of a fixed place of business means that the taxation of the profits of an enterprise in the other contracting state is only allowed when there is an **intensive economic connection** to that state (Vogel, *DTC* Art. 5, m.no. 22) or a **"physical location at the disposal of the enterprise"** (Baker, *DTC* 5 B.06). A place of business encompasses all things (physical objects) that serve the enterprise (GE, RFH 30 Apr. 1935). In borderline cases, a single object may suffice (Vogel, *DTC* Art. 5, m.no. 23). According to this definition, a PE does not necessarily need to be a room. It is crucial, however, that the place of business be not only temporarily at the disposal of the entrepreneur; the actual possibility of disposal is sufficient. Thus, if the premises are at the entrepreneur's disposal only from time to time, this does not suffice to constitute a PE. Furthermore, a PE must be a **"permanent" place of business**. The place of business must be created "with a certain degree of permanence" (Vogel, *DTC* Art. 5, m.no. 28). In some DTCs, a time limit of six months is provided as a guideline. Finally, a connection to a certain point of the earth's surface must exist (Vogel, *DTC* Art. 5, m.no. 24).

249 ***Example:*** *A company resident in the United Kingdom renders recruitment services in India. For this purpose web space and a telephone address in India has been rent. The website and telephone are merely used for communication and serve as a contact point. The company therefore has no office or business place in India but only a "virtual office", which does not constitute a PE (cf. IN, AAR 5 Mar. 2010, Real Resourcing Limited v. DIT (International Taxation)-II New Delhi, AAR/828/2009).*

250 A **list** in Art. 5(2) OECD Model provides examples of what is meant by "PE". According to this paragraph, a PE especially includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. It is unclear whether the examples mentioned in Art. 5(2) OECD Model are in every case regarded as PEs. According to prevailing opinion, the examples have to be seen in the light of the general definition of "PE" in Art. 5(1) OECD Model. They can therefore only constitute PEs if the requirements of the general definition are fulfilled. (cf. OECD Commentary on Art. 5, para. 12; also Vogel, *DTC* Art. 5, m.no. 47; also Baker, *DTC* 5 B.14).

251 *Example: A Canadian furniture producer attends a trade fair in Chicago. The trade fair lasts 1 week. Since the "permanence test" must be fulfilled for the enterprise to constitute a PE under the general definition of Art. V(1) of the Canada–US DTC (Art. 5(1) OECD Model), the stand at the trade fair is not a PE (Vogel, DTC Art. 5, m.no. 47).*

252 **Building sites and construction or installation projects** are specifically mentioned in Art. 5(3) OECD Model. They are only regarded as PEs when they last longer than 12 months. Mentioning building and construction sites explicitly does not widen the PE concept but merely explains it. Since the permanence of the PE is uncertain in these cases, the treaty clarifies when a sufficiently solid connection of a normally temporary activity can be assumed in order to classify the arrangement as a PE. The 12-month period is therefore of importance where the existence of a PE is otherwise doubtful. **Art. 5(3)(a) UN Model** differs from the OECD Model in two ways: firstly, the scope of the provision is wider since it expressly includes "assembly projects" and "supervisory activities" in connection with building sites, construction, installation or assembly projects to constitute a PE; secondly, the required duration is reduced to 6 months.

253 Art. 5(4) OECD Model excludes certain **preparatory and auxiliary activities** from the definition of a PE. The taxation by the state in which such activities are performed is not as evidently legitimate as taxation of more direct activities. Furthermore, in practice, it is especially difficult to determine the share of business profits that should be allocated to these auxiliary activities (Vogel, *DTC* Art. 5, m.no. 108). The range of exclusions from the definition of a PE is narrower in Art. 5(4) UN Model because facilities used solely for the purpose of delivery and stock maintained only for the purpose of delivery are not mentioned.

254 *Example: According to Art. 5(4)(d) OECD Model, a fixed place of business whose only purpose is to obtain information for the company is not regarded as a PE. Consequently, newspapers that provide their correspondents with offices do not establish PEs in those states. As long as the company only acquires the information, a PE is not constituted. However, if the information is processed in a fixed place of business – in the sense of an evaluation or editorial department – the enterprise constitutes a PE. Thus, editorial departments of newspapers are not exempt under Art. 5(4) OECD Model (Vogel, DTC Art. 5, m.no. 114).*

255 An **agent** can also be regarded as a PE. The requirements are set forth in Art. 5(5) OECD Model: the agent must have, and habitually exercise, in a contracting state an authority to conclude contracts in the name of the enterprise; if, however, the activities of the agent are restricted to the activities listed in Art. 5(4) OECD Model, the agent does not constitute a PE for the enterprise. According to the concept of Art. 5(4) UN Model, a person without authority to conclude contracts in the name of the enterprise is nonetheless considered a dependent agent in the case that the person maintains a stock of goods or merchandise to deliver on be-

half of the enterprise. However, as Vogel points out, constituting a PE in such a way can easily be avoided (Vogel, *DTC* Art. 5, m.no. 147a).

256 ***Example:*** *An Indian company marketed examination/certification programmes offered by a US-based organization. The company's main activity was the collection of registration forms and examination fees from Indian residents. The question was whether the Indian company constituted a PE for the US organization under Art. 5 India–US DTC. Since the company did not conclude any contracts on behalf of the US organization and did not maintain a stock of goods or secure orders for the US organization, it was found to be an independent agent. Independent agents do not lead to the establishment of a PE (IN, AAR 30 Apr. 2008, KnoWerX Education (India) Pvt. Ltd. v. Inland Revenue, AAR/744/2007).*

257 In contrast to the OECD Model, the UN Model includes an additional provision on PEs of insurance companies (**Art. 5(6) UN Model**), stipulating that an insurance company collecting premiums in another state is regarded to have a PE in that other state.

258 If an enterprise carries on business through a broker, general commission agent or any other agent of independent status, this will not constitute a PE provided that the person acts in the ordinary course of his/her business. This provision exists merely for clarification: an entrepreneur who is acting in the course of his/her own business does not thereby constitute a PE for another person. This is not the case when he/she pursues the interests of someone else. Art. 5(6) OECD Model clarifies this (Vogel, *DTC* Art. 5, m.no. 168). The corresponding provision in the UN Model is Art. 5(7). In contrast to the OECD Model, it specifies that an agent is not regarded to be independent if his/her activities are devoted wholly or almost wholly to one enterprise and the conditions made or imposed between the agent and the enterprise differ from the conditions between independent parties.

259 Art. 5(7) OECD Model emphasizes that a **subsidiary** does not automatically constitute a PE of the parent company. However, if the requirements of Art. 5(1) or (5) OECD Model are met, a subsidiary can constitute a PE of the parent in the same way as any other company would.

260 ***Example:*** *An Irish computer manufacturer has a 100% share in an Icelandic subsidiary. This subsidiary has the authority to conclude contracts in the name of the parent company and habitually exercises this authority. The subsidiary consequently constitutes an agency PE for the Irish parent and the parent becomes liable to tax in Iceland in respect of the profits attributable to the Icelandic agent (Art. 7(1) and Art. 5(5) of the Iceland–Ireland DTC). Of course, the Icelandic subsidiary, as a resident of Iceland, is also subject to tax in Iceland.*

261 For **services** no special provisions exist; they are to be treated like every other type of business income. Therefore, profits arising from providing services may only be taxed in the source state if they are attributable to a PE. However, since

the 2008 update, the OECD Commentary on Art. 5 contains an alternative view that represents a minority of OECD Member countries. Following this new approach, contracting states may include a "service PE provision" in their DTCs in order to secure the taxing right of the source state with respect to profits from services provided therein. Such a provision expands the circumstances under which a PE arises because of the provision of services, by deeming services to be carried out through a PE, if certain thresholds are met. A sample provision can be found at para. 42.23 of the OECD Commentary on Art. 5: a PE will be constituted if the service provider is present in the source state for more than 183 days within a 12-month-period and if the enterprise derives more than 50% of its gross revenues from the provision of this service. Since this new opinion is only supported by a minority of OECD Member countries, it remains to be seen in how many DTCs similar provisions will be included (cf. Dunahoo/Sprague, *BFIT* 2009, 191 et seq.). **Art. 5(3)(b) UN Model** includes a provision similar to the concept proposed in the 2008 OECD Commentary on Art. 5, para. 42.23. Thus, an enterprise is deemed to have a PE in the other contracting state due to the performance of services exceeding a period or periods aggregating more than 6 months within any 12-month period. There exists no threshold as regards the amount of gross revenue derived from the provision of these services.

262 Art. 7 OECD Model contains rules regarding the attribution of profits to a PE. According to Art. 7(2) OECD Model, the **arm's length principle** must be applied: there shall be attributed to the PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions. Thus, in attributing profits, the PE must be assumed to be dealing independently with the enterprise of which it is a PE. The scope of this virtual independence is controversial. According to one opinion, only an absolute independence of the PE fulfils the requirements of the arm's length principle of Art. 7(2) OECD Model. However, other authors assume a restricted independence of the PE, whereby the PE is regarded as a dependent part of the enterprise. Costs can only be taken into account when they have an effect on the expenses of the whole enterprise (GE, BFH 20 Jul. 1988, I R 49/84).

263 As there has been considerable variation in the interpretation of the attribution, the OECD has worked on a report regarding the attribution of profits to PEs, in which the **"functionally separate entity approach"** is considered as the guiding principle in the interpretation of Art. 7 OECD Model. Under the so-called "authorized OECD approach (AOA)", a functional analysis has to be carried out before transactions within various parts of a single enterprise ("dealings") have to be priced at arm's length, giving rise to a profit element. The OECD Transfer Pricing Guidelines that have been developed for transactions between associated enterprises (Art. 9 OECD Model) shall be applied by analogy also for the purposes of Art. 7 OECD Model (cf. m.no. 460 et seq.).

264 The **AOA** should be implemented in two steps. In the update of the OECD Model 2008, only changes in the Commentary on Art. 7 OECD Model have been enacted to include the interpretation of the AOA. As the OECD Model has not been changed, the separate entity approach could not be enacted completely. As a second step in the implementation of the AOA into DTCs, in the 2010 update of the OECD Model, changes in the wording of Art. 7 OECD Model as well as changes in the Commentary have been included. The AOA will therefore be fully implemented, if future DTCs will be negotiated on the basis of the Art. 7 OECD Model 2010.

265 Art. 7 OECD Model contains rules for the **determination of the PE's profits**. Expenditures resulting from the PE's activities must be deductible, whether they are incurred in the PE State or elsewhere. This is especially true for management and general administrative costs. Furthermore, Art. 7(5) OECD Model 2008 states that no profits shall be attributed to a PE merely by reason of the purchase of goods or merchandise by the PE for the enterprise.

266 Art. 7(4) OECD Model 2008 provides for another method of determining profits. The profits of the PE can also be determined by dividing the total profits of the company into its respective parts. The chosen method of division and its results must be in conformity with the principles of Art. 7 OECD Model. This condition ties Art. 7(4) OECD Model 2008 to what is usual in one of the contracting states. In addition, the profits to be attributed to the PE shall be determined by the same method year after year (Art. 5(6) OECD Model). However, this **indirect method** of calculating the profits is not allowed in all DTCs: e.g. the most recent DTC between Austria and the United States excludes this method of calculation of profits.

267 Art. 7(7) OECD Model 2008 (Art. 7(4) OECD Model 2010) is a rule that explains how Art. 7 OECD Model applies. According to this rule, other **allocation rules** of the OECD Model **take precedence over Art. 7** OECD Model. As a result, Art. 7 OECD Model is overridden and only applies when other allocation rules do not.

268 ***Example:*** *A South African enterprise receives dividends from Tanzania. Pursuant to Art. 7(7) of the South Africa–Tanzania DTC, which corresponds to the OECD Model, the dividend income falls within the scope of Art. 10 and not of Art. 7 of that DTC. Even though there is no PE in Tanzania, the source state has a taxing right. The situation would be different if the enterprise had a PE in Tanzania, to which the shares, in respect of which the dividends were paid, were connected. In this case, the PE proviso of Art. 10(4) would apply (cf. m.no. 287). This is a special provision which overrides Art. 7(7) South Africa–Tanzania DTC so that Art. 7 of that DTC applies. If the South African enterprise had a PE in Tanzania to which the dividend income was attributable, Tanzania as the PE state would have the right to tax the dividends under Art. 7(1).*

269 As regards the attribution of profits to a PE, apart from the fact, that under the UN Model there are more situations leading to a PE than under the OECD Model,

another difference can be found in **Art. 7(3) UN Model**. This provision denies deduction in respect of amounts paid (otherwise than towards reimbursement of actual expenses) by the head office to the PE (or vice versa) by way of royalties, fees or similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed and for management, or (except in the case of banking enterprises) by way of interest on money lent. However, the UN Model leaves it open for bilateral discussions whether the mere purchase of goods or merchandise by a PE leads to profits that are attributed to the PE, while the OECD Model 2008 in Art. 7(5) clearly states that this is not the case. So it can be argued that materially speaking, the differences regarding royalties, fees and similar payments are not very substantial: both models have in common that interest payments between the PE and the head office should be accepted only in the case of reimbursement of actual expenses (cf. Vogel, *DTC* Art 7, m.no. 105; Kosters, *Asia-Pacific Tax Bulletin* 2004, 6).

3. Shipping, inland waterways transport and air transport

3.1 Shipping, inland waterways transport and air transport

270 **Art. 8 OECD Model** applies to the operation of ships or aircraft in international traffic. The concept of "international traffic" is defined in Art. 3(1)(e) OECD Model. It means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a contracting state, except when the ship or aircraft is operated solely between places in the other contracting state. Therefore, if the ship or aircraft is located in the other contracting state and is not crossing borders, Art. 8 OECD Model does not apply.

271 ***Example:*** *An airline has its place of effective management in the United Arab Emirates and, amongst others, conducts flights between Bangkok and Phi Phi Island (both in Thailand). The profits resulting from this route are not covered by Art. 8 of the Thailand–United Arab Emirates DTC because these flights do not involve international traffic. Instead, Art. 7 Thailand–United Arab Emirates DTC applies. Provided that the income is attributable to a PE of the enterprise situated in Thailand, the PE state has a right to tax.*

272 Art. 8(2) OECD Model also includes profits from the operation of ships of **inland waterways transport**. This applies even if there is no international traffic.

273 ***Example:*** *A shipping enterprise with its place of effective management in Romania offers daily trips on the Danube between Regensburg and Ulm, Germany. Under Art. 8(2) of the Germany–Romania DTC, Romania has the exclusive taxing right with respect to these earnings. Even though the trips are conducted entirely in Germany, the DTC provides that the profits are taxable only in the contracting state where the enterprise's place of effective management is situated.*

3.2 Allocation of taxing rights

274 Art. 8(1) OECD Model gives the exclusive taxing right to the state in which the **place of effective management** of the enterprise is situated. The application of the exemption or the credit method is therefore not required and the PE principle, which would otherwise be decisive for business profits, is overruled.

275 ***Example:*** *A Vietnamese airline company offers flights between Amsterdam and Vietnamese cities and has a representative office in Amsterdam. Since Art. 8 takes precedence over Art. 7 in the Netherlands–Vietnam DTC, the PE principle does not apply. If the place of effective management of the enterprise is situated in Vietnam, Vietnam has the exclusive right to tax while the Netherlands may not tax at all.*

276 Contrary to the OECD Model, the UN Model offers two alternatives for the allocation of taxing rights regarding profits of ships in international traffic. The wording of Art. 8A UN Model is the same as of the OECD Model but **Art. 8B(2) UN Model** follows a different concept: the state in which the place of effective management is located always has a right to tax, but if the activities of the shipping enterprise in the other state are more than casual, Art. 8B(2) UN Model grants this state a limited taxation right. The apportionment of profit is largely left to bilateral negotiations, as the UN Model merely states that the tax base is to be determined on the basis of the overall net profits from the enterprise's shipping activities and the amount of tax due in the other state shall be reduced by a certain percentage.

4. Dividends

4.1 Dividends

277 Dividends are regulated in **Art. 10 OECD Model**. The concept of "dividends" for purposes of the treaty is defined in Art. 10(3) OECD Model by a list of examples: income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt claims, and participating in profits. All the profit-sharing rights listed in Art. 10(3) OECD Model must be "corporate rights". This becomes clear when the treaty speaks of "other corporate rights" and consequently affirms that by the term "dividends", only income from such rights are meant. The definition of dividends restricts the concept to those distributions by companies that are fiscally equal to the income from corporate rights according to national law of the distributing company's residence state. Apparently, the OECD Model assumes that income from corporate rights can only qualify as "dividends" if it is not deductible when determining the profits of the distributing company.

278 The notion of **"corporate rights"** is therefore decisive for the dividend concept. Only "corporate rights" can qualify for the purposes of Art. 10 OECD Model. On the one hand, the concept's prerequisite is the existence of a "company". This

concept is defined in Art. 3(1)(b) OECD Model. This term means any body corporate or any entity that is treated as a body corporate for tax purposes. Thus, all tax subjects that are not individuals are regarded as "companies" in DTCs. On the other hand, there must be a "share" in a company so that one can speak of dividends. This concept is not defined by tax treaty law. However, it has to be distinguished from the concept of the "receivables" ("not being debt claims"). In contrast to a creditor, a shareholder has to participate in current profits and in liquidation proceeds.

279 ***Example:*** *An open-ended investment fund organized under and governed by Finnish law and enacted according to the EC Directive on undertakings for collective investment in transferable securities (UCITS), contemplated distributions to unit holders resident in Sweden and Canada. It applied for an advance ruling to clarify its withholding obligations. The Central Tax Committee gave its ruling on 2 Mar. 1998, holding that distributions made by investment funds were not subject to the same taxation treatment as income from shares under Finnish tax law, hence they were not "dividends" for tax treaty purposes. The ruling was appealed by the Representative of the Revenue. The Finnish Supreme Administrative Court (KHO) held that the distributions did not qualify as "dividends" for tax treaty purposes, since an investment fund is not a corporation; only the fund management company is a corporation. Moreover, the same withholding tax treatment of fund distributions and dividends under Sec. 3 of the Law on Taxation of Non-residents cannot be used to interpret the nature of distributions, since the differentiation exists due to practical reasons (FI, KHO 14 Jun. 1999, 14.06.1999/1600).*

4.2 Allocation of taxing rights

280 Under Art. 10 OECD Model, the **residence state of the recipient** of the dividends has the right to tax. The source state is also entitled to tax but this tax will be restricted to a certain percentage if the recipient is the beneficial owner of the dividend. The taxes paid in accordance with the tax treaty in the **source state** can be credited in the residence state. This is guaranteed by Art. 23 OECD Model.

281 ***Example:*** *An individual resident in Hong Kong receives dividends from Luxembourg. Under Art. 10(1) of the Hong Kong–Luxembourg DTC, Hong Kong may tax this income. However, Luxembourg also has the right to tax but the taxes so charged shall not exceed 10%. Under Art. 22 (method article) of the treaty, the taxes withheld in Luxembourg must be credited against Hong Kong's taxes payable.*

282 Generally, the **source state's right to tax** is limited. The OECD Model limits the taxing rights to 15%. If, however, the recipient of the dividends is a corporation that directly holds at least 25% of the stock of the company paying the dividends, the OECD Model provides for a reduction to 5%. Different rules are found in many bilateral DTCs, like in the following example.

283 ***Example:*** *A Russian company receives dividends from Mongolia. According to Art. 10(2) of the DTC between Mongolia and Russia, the source state may withhold taxes not exceeding 10%. The same would apply if the recipient of the dividends were an individual. Russia has the right to tax, but under Art. 24 of the Mongolia–Russia DTC, the credit method must be applied. If, however, the dividend income is exempt under Mongolian law, Russia must also exempt this income from taxation.*

284 Unlike the OECD Model, the **UN Model** does not stipulate any rates of withholding tax but leaves the certain percentage to be established through bilateral negotiations. This, of course, does not eliminate distribution conflicts, but only perpetuates them to the level of the contracting states (in detail, cf. Ritter, *DStZ*/A 1979, 427). Moreover, pursuant to Art. 10(2)(a) UN Model, the threshold to differentiate between direct and portfolio investments is as low as 10%.

285 Art. 10 OECD Model is only applicable if the recipient of the dividends resides in one contracting state and the **dividends are paid by a company resident in the other contracting state**. If the dividend originates in the residence state of the recipient, Art. 10 OECD Model does not apply. The same holds true for dividends originating in third states.

286 **Example:** *An individual resident in Switzerland receives dividends from a company that has its legal seat in France but its place of effective management in Switzerland. Under the tiebreaker rule of Art. 4(3) of the France–Switzerland DTC (identical to Art. 4(3) OECD Model), the company is deemed to be a resident of Switzerland. The place of effective management takes precedence over the legal seat. Since the distributing company and the recipient of the dividends are both residents of the same contracting state, Art. 10 OECD Model is not applicable. If the recipient of the dividends holds the shares as private property, Art. 21 OECD Model applies. Under this provision, Switzerland has the exclusive taxing right and France must not deduct withholding tax.*

287 According to Art. 10(4) OECD Model, the dividend rules are not applicable if the recipient of the dividends, resident in one contracting state, carries on business through a PE in the other contracting state, in which the distributing company is resident, and the shares actually belong to this PE. According to this so-called **“PE proviso”** (translation of the German word “Betriebstättenvorbehalt”, cf. Vogel, *DTC* pre Art. 10–12, m.no. 15 et seq.), the provisions of Art. 7 OECD Model take precedence over Art. 10 OECD Model.

288 ***Example:*** *A tax adviser works in France and has an office there but resides exclusively in Germany. Among her business assets in France, she holds a share in a French consulting company from which she receives dividends. Under the PE proviso of Art. 9(8) of the France–Germany DTC, the provisions for dividends do not apply because the recipient’s fixed base and the distributing company are both in the same state, and Art. 4 (business profits)*

is applicable. The PE proviso of Art. 9(8) of the France–Germany DTC does not expressly apply to professional services. Nevertheless, its principles are also applicable to Art. 12 (professional services). Under this provision and the method article (exemption method), the dividends may be taxed in France, whereas Germany must exempt them from taxation.

289 Within the EU, special provisions in respect of dividend income exist. Under the **Parent-Subsidiary Directive** (Council Directive 90/435/EEC of 23 Jul. 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225 of 20 Aug. 1990, 6–9), distributions of profits of a corporation resident in an EU Member State to a corporation resident in another EU Member State, under certain conditions, should not be subject to any tax at source. The limitations of the source tax contained in Art. 10(2) OECD Model therefore do not apply. Under tax treaty law this is unproblematic. It is up to each DTC partner whether or not to apply the source state's taxing rights assured by the DTC under their domestic law. Therefore, it is not a violation of the DTC if the source state is forced by the Parent-Subsidiary Directive not to levy withholding taxes.

290 ***Example:*** *A German corporation holds a 100% share in a French corporation. If the other prerequisites (e.g. holding period) are fulfilled, no tax at source can be withheld in France. However, Art. 10 of the Germany–France DTC provides for a 5% source tax. Nevertheless, France must not exercise its taxing right by reason of the EC Parent-Subsidiary Directive.*

5. Interest

5.1 Interest

291 **Art. 11 OECD Model** regulates interest payments. Art. 11(3) OECD Model defines the term "interest" as income from debt claims of every kind. The term "debt claims" is not defined but must be contrasted with "dividend". From the list of examples provided in Art. 11(3) OECD Model, one could conclude that "debt claims" in terms of tax treaty law could also be connected with a participation in the profits of the debtor. However, if the contract also allows for a participation in the liquidation proceeds, it is likely regarded as a share, not a debt claim. In this case, the payments are dividends and Art. 10 OECD Model is applicable. The distinction between dividends and interest is not always easy and might differ from country to country. Nevertheless, for DTC purposes, only the treaty definition is relevant.

292 ***Example:*** *A Czech company received a loan from an associated company resident in the Netherlands. The loan exceeded four times the equity of the company. The interest payments and the principal of the loan depended on the profits of the company. Following domestic thin capitalization rules, the Czech authorities requalified these payments as dividends. The company was*

therefore required to withhold taxes at source as though the payments had been dividends. This did not mean, however, that for the purposes of the Czech Republic–Netherlands DTC, the payments were to be characterized as dividends. Art. 10 of the DTC contains an independent definition of dividends. Under this definition, dividends are income from "other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident". A loan can never be a corporate right because it does not give rise to the right to participate in the profits, control or surplus on liquidation. Consequently, the payments at hand constituted interest for the purposes of the DTC (cf. CZ, NSS 10 Feb. 2005, 2Afs 108/2004–106).

5.2 Allocation of taxing rights

293 According to Art. 11 OECD Model, the **residence state** of the recipient of the interest has the right to tax the interest. The **source state's** right to tax is restricted to a certain percentage. The taxes paid in accordance with the tax treaty in the source state will be credited in the residence state, as set out in Art. 23 OECD Model.

294 ***Example:*** *A person resident in Syria receives interest payments from the Slovak Republic. Under Art. 11(1) of the Slovak Republic–Syria DTC, the Slovak Republic has the right to withhold source tax to a maximum of 10%. Double taxation is eliminated by means of the credit method.*

295 Generally, the **taxing right of the source** state is limited: the OECD Model limits it to 10%. In practice, however, numerous DTCs provide for deviating source tax rates and, under some DTCs, source tax is not levied at all. The **residence state** usually retains the right to tax interest. The **UN Model** follows the same approach to interest as to dividend payments and does not provide for a certain withholding tax rate.

296 ***Example:*** *A person resident in Hungary receives interest from a Macedonian savings account. Under Art. 11(1) of the DTC between Hungary and Macedonia, the residence state of the recipient has the exclusive right to tax. No tax at source may be withheld. If the same person were to receive the interest payments from a Romanian source, a withholding tax of 15% would apply (Art. 11(2) Hungary–Romania DTC).*

297 Art. 11 OECD Model only applies when the recipient is resident in one contracting state and the **interest arises in the other contracting state**. Consequently, if the interest arises in the residence state of the recipient of the interest, or the interest arises in a third country, Art. 11 OECD Model does not apply.

298 Art. 11(4) OECD Model contains the **PE proviso** for interest. The provisions of Art. 11(1) and (2) OECD Model are not applicable if the recipient of the interest carries on business through a PE in the contracting state in which the interest arises and the receivable, upon which the interest is paid, belongs to this PE. In

this case, Art. 7 OECD Model takes precedence. **Art. 11(4) UN Model** differs from the OECD Model as this provision extends the "limited force of attraction principle" mentioned in Art. 7(1)(c) UN Model. Hence, interest payments arising from transactions of the same or similar kind outside a PE or fixed base do not fall into the scope of Art. 11 UN Model, so that Art. 7 or Art. 14 UN Model is applicable.

299 ***Example:*** *A Maltese company has a PE in Egypt. The Egyptian PE has a bank deposit with an Egyptian bank from which it receives interest. If the bank deposit is actually connected to the PE, Art. 11 of the Egypt–Malta DTC does not apply because the PE proviso takes precedence. Consequently, Art. 7 Egypt–Malta DTC (business profits) is applicable, and the interest income is attributed to the PE and is taxed in the PE state. Malta will apply the credit method (Art. 22(1) of the Egypt–Malta DTC) to prevent double taxation.*

6. Royalties

6.1 Royalties

300 Royalties are regulated by **Art. 12 OECD Model**. The concept is defined in Art. 12(2) OECD Model as payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work. Patents, trademarks, designs or models, plans, secret formulas or processes, or the information concerning industrial, commercial or scientific experience are specifically mentioned. However, tax treaties sometimes use other definitions for royalties.

301 ***Example:*** *In former versions of the OECD Model (prior to 2002), Art. 12 OECD Model included remuneration for the use of, or the right to use, industrial, commercial or scientific equipment. In particular, this applied to leasing payments. The Jordan–Turkey DTC follows this former OECD Model and provides for a 12% source tax for such income. This also holds true for the* ***UN Model*** *and, apart from that, "films or tapes used for radio and television broadcasting" are explicitly mentioned.*

6.2 Allocation of taxing rights

302 According to Art. 12 OECD Model, the residence state has exclusive taxing rights; the source state is not entitled to raise taxes. Consequently, Art. 23 OECD Model does not apply. However, numerous DTCs deviate from the provisions of Art. 12 OECD Model. The right to raise taxes on royalties in the source state is typically found in older DTCs, as well as in treaties following the UN Model. The taxing right of the source state is limited again as it is the case with dividends and interest payments. This allocation rule illustrates the way the **UN Model** is designed to take into account the special circumstances of developing countries, which typically are source states in respect of royalty payments. Over the past

few years, the tax treaty practice of many countries has changed and more and more DTCs no longer include taxing rights for the source state.

303 ***Example:*** *A Turkish company leases copyrights to a company resident in Bahrain and receives royalties. Under Art. 12(1) of the Bahrain–Turkey DTC, Turkey has the taxing right but Bahrain can withhold 10% tax at source (Art. 12(2)). Under the method article (Art. 22 of the Bahrain–Turkey DTC), Turkey must credit the withholding tax against the tax payable in Turkey on the royalties.*

304 Royalties only fall within the scope of Art. 12 OECD Model, if they **arise in one contracting state** and are paid to a person resident in the **other contracting state**. When royalties arise in the same contracting state in which the recipient of the royalties is resident, Art. 12 OECD Model does not apply. This also holds true for royalties from third countries.

305 Like Art. 10 and 11, Art. 12 OECD Model contains a **PE proviso**. According to Art. 12(3) OECD Model, Art. 12(1) does not apply if the recipient of the royalties, resident in a contracting state, carries out business through a PE in the contracting state in which the royalties arise and the right or assets for which the royalties are paid belong to this PE. In this case, Art. 7 OECD Model applies and the PE state has the right to tax.

306 ***Example:*** *A Mexican sole trader has a PE in Barbados, which developed a special technical procedure. This technique is made available to a Barbadian company. The royalties received by the Mexican company are effectively connected to the PE in Barbados and, consequently, the PE proviso applies. Instead of Art. 12, Art. 7 of the Barbados–Mexico DTC is applicable. Barbados, as the PE state, has the right to tax and Mexico must allow a credit (Art. 24(1) Barbados–Mexico DTC).*

307 Due to royalties being exempt in the source state, there is no provision in the OECD Model dealing with where royalties are **deemed to arise**. However, since the UN Model grants the source state a limited taxation right, the question where royalties are deemed to arise is addressed in **Art. 12(5) UN Model**: it depends on where the payer is resident. Also, DTCs that are patterned after the OECD Model but still provide for a withholding tax normally include according provisions (cf. Baker, *DTC* 12 B.05).

7. Capital gains

7.1 Alienation

308 **Art. 13 OECD Model** regulates capital gains. The prerequisite for the application of Art. 13 OECD Model is the existence of an alienation. The concept is not defined in tax treaties. From the context of the convention, it is inferred that an alienation is the transfer of the ownership of the asset in return for payment. The question whether certain dealings are regarded as alienations has to be de-

termined exclusively in the context of the treaty (cf. also Baker, *DTC* 13 B.04). Transactions in one of the two contracting states, which are merely put on par with alienations by means of domestic legislation, are therefore not necessarily alienations in the sense of a tax treaty.

309 ***Example:*** *A resident of the Netherlands holds a 100% share in a Dutch company. In the year X1 he moves to Belgium and a year later (in X2) he sells all the shares to a bank, provided that it liquidated the company (liquidation clause). Under Dutch domestic law, the income arising from such alienation of shares constitutes "income from capital". Now the question was whether the Netherlands had a taxing right under Art. 13(5) of the Belgium–Netherlands DTC, which provides for a source tax of 20% (which is a deviation from the OECD Model). The Dutch tax administration argued that Art. 13(5) of the treaty did not apply because in domestic terms this income was not regarded as a capital gain. However, the Netherlands Supreme Court ruled that regardless of the classification of the income under domestic law, Art. 13 did also include the sale of shares with a liquidation clause, because the term capital gains had an independent meaning in the treaty (NL, Hoge Raad 3 Jul. 1991, Case 25.308; discussed by Smit, ET 1992, 57 et seq.).*

7.2 Allocation of taxing rights

310 **Art. 13 OECD Model** contains five paragraphs, each of which contains an independent sub-allocation rule. Every capital gain is to be assigned to one of the paragraphs of Art. 13 OECD Model. If the application of the first four paragraphs of Art. 13 fails, the blanket clause contained in Art. 13(5) OECD Model applies.

311 The legal consequences vary: Art. 13(1) OECD Model deals with the **alienation of immovable property**. In accordance with Art. 6 OECD Model, the taxing rights are allocated to the state in which the property is situated. Whether the residence state can also assert taxing rights depends on Art. 23 OECD Model, which provides the applicable method for the elimination of double taxation.

312 ***Example:*** *A person resident in Armenia owns Italian property and sells it. Under Art. 13(1) of the Armenia–Italy DTC, the situs state (Italy), may tax the gain arising from the alienation. Art. 24 of the DTC (Art. 23 OECD Model) provides that Armenia has to deduct – from the taxes payable – the taxes paid in Italy (credit method).*

313 The **concept of immovable property** is defined in Art. 6 OECD Model. Art. 13(1) OECD Model refers to this provision. The rule only applies if the immovable property is situated in one contracting state and the recipient of the capital gain is resident in the other contracting state. If the alienated immovable property is situated in the residence state of the alienator or in a third country, Art. 13(1) OECD Model does not apply. The blanket clause of Art. 13(5) OECD Model will then apply, so that the residence state of the alienator has the right to tax.

314 Capital gains from the alienation of movable property forming part of the **business property** of a PE situated in the other contracting state may be taxed in

the PE state. Again, the residence state's right to tax depends on Art. 23 OECD Model. The residence state can either tax the capital gain and credit the taxes paid in the PE state or exempt the gain (with progression). The assets covered under Art. 13(2) OECD Model can be determined by reference to Art. 7 or Art. 14 OECD Model.

315 **Capital gains from the alienation of ships or aircraft** operated in international traffic, as well as capital gains from the alienation of boats engaged in inland waterways transport and from movable property pertaining to the operation of such ships, aircraft or boats, are covered by Art. 13(3) OECD Model. The right to tax is assigned to the state in which the place of effective management of the enterprise is situated. This state has the exclusive taxing right, which means that Art. 23 OECD Model is superfluous. These legal consequences correspond to the legal consequences for business profits from the operation of such companies under Art. 8 OECD Model. Art. 8 OECD Model is also relevant for determining the content of the concepts of shipping, inland waterways transport and air transport.

316 Pursuant to Art. 13(4), gains from the **alienation of shares** deriving more than 50% of their value directly or indirectly from immovable property situated in a contracting state may be taxed in that state. Whether the residence state can also tax will depend on Art. 23 OECD Model, which provides the applicable method for the elimination of double taxation. In this regard the **UN Model** slightly deviates from the OECD Model, because it encompasses not only shares but also interest in a partnership, trust or estate, as long as the property of which consist "principally" of immovable property situated in a contracting state. Pursuant to Art. 13(4)(2) UN Model, the term "principally" also means a 50% threshold – like in the OECD Model. In Art. 13(4)(1) UN Model it is clarified that entities whose property consists principally of immovable property used by them in their business activities are excluded from the provision, unless they are not immovable property management companies, partnerships, trusts or estates.

317 Art. 13(5) OECD Model is the **blanket clause**. The alienation of every asset not covered by Art. 13(1) to Art. 13(4) OECD Model falls under Art. 13(5) OECD Model. The right to tax these capital gains is exclusively assigned to the residence state of the recipient. Art. 23 OECD Model is therefore not required.

318 Art. 13(5) OECD Model covers **capital gains** from the alienation of assets **not discussed in the first four allocation rules**. Above all, participations not covered by Art. 13(4), receivables, know-how and patents are covered by this provision, insofar as these assets are not attributable to a PE in a state other than the residence state of the recipient (Art. 13(2) OECD Model), or belong to a company operating in the field of air transport, shipping or inland waterways transport (Art. 13(3) OECD Model). Moreover, this rule covers PE assets if the PE is situated in a third country or in the residence state of the alienator. Finally, the alienation of assets that are not covered by any other allocation rule, and do not serve in the realization of profits, falls under Art. 13(5) OECD Model, pursuant to which the alienator's residence state has the exclusive taxing right.

319 ***Example:*** *A resident of Austria with an apartment in Switzerland owns jewellery. When this person sells the jewellery, the blanket clause of Art. 13(3) Austria–Switzerland DTC provides that the residence state of the alienator has the right to tax. Under Austrian domestic law, the gains may or may not be taxed, depending on how long the person owned the jewellery. If the jewellery is sold during the so called "speculation period", the person must pay income tax in Austria. If, however, the sale takes place outside the "speculation period", the sale is not taxable. Therefore, even though the treaty allocates the taxing right to Austria, it is possible that no tax will be imposed under Austrian domestic law. The treaty does not give rise to an independent right to tax (cf. m.no. 46).*

320 Numerous OECD Member countries have reserved the right to include in their DTCs a provision similar to Art. 13(5) UN Model. This additional article rules that capital gains from the **alienation of shares other than those in immovable property companies**, representing a certain percentage of the share in a company, which is a resident of a contracting state, may be taxed in that state. The intention of this regulation bases on the assumption that such a shareholder can control the dividend policy of the company and is therefore in a position to transform dividends, which are subject to withholding tax in the source state, into capital gains, which, under the OECD Model, are taxable only in the residence state of the alienator. The percentage of the minimum shareholding is to be established trough bilateral negotiations. Art. 13(5) UN Model underlines the focus of the UN Model on the special requirements of developing countries, as these countries typically are in the position of the source state.

321 ***Example:*** *Art. 12(5) China–France DTC (Art. 13(5) UN Model) stipulates that gains derived from the alienation of shares, other than those mentioned in Art. 12(4) of that DTC and which represent a participation of 25% in a company that is a resident of a contracting state, may be taxed in that contracting state.*

8. Independent personal services

8.1 Independent personal services

322 Prior to 2000, the OECD Model contained a separate provision for the **income from independent personal services** in Art. 14. The OECD Committee on Fiscal Affairs eliminated this allocation rule without replacing it with another. The Committee believed that Art. 14 OECD Model essentially had the same legal consequences as Art. 7 OECD Model and was therefore superfluous. All income previously assigned to the former Art. 14 OECD Model is now covered by Art. 7 OECD Model. However, since it will still take some time for Art. 14 OECD Model to disappear from bilateral tax treaties, the former Art. 14 OECD Model is explained below.

323 The **concept of services** is defined in the former Art. 14(2) OECD Model. In particular, it includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. For an activity to be categorized as other independent services, it must be comparable to the liberal professions.

324 From the list of services set out in former Art. 14(2) OECD Model, one can identify **two criteria** by which independent personal services differ from business profits (Art. 7 OECD Model). First, former Art. 14 OECD Model primarily covers services. Second, the amount of capital expenditure characteristically does not play a decisive role in the field of former Art. 14 OECD Model (Vogel, *DTC* Art. 14, m.no. 15). However, the legal consequences of former Art. 14 OECD Model resemble the legal consequences of Art. 7 OECD Model. Therefore, the distinction between Art. 7 OECD Model and former Art. 14 OECD Model often only plays a minor role in practice.

325 ***Example:*** *A consultant resident in Poland has an office in Norway. The issue is whether the profits can be attributed to the Norwegian office under Art. 7 (business profits) or under Art. 14 (independent personal services) of the Norway–Poland DTC. According to these rules, Norway has the right to tax the profits attributable to a PE (Art. 7 Norway–Poland DTC) and to a fixed base (Art. 14 Norway–Poland DTC). Under both rules, Poland is required to exempt the income from tax; however, the progression clause remains applicable.*

326 Nonetheless, the **distinction between Art. 7 OECD Model and former Art. 14 OECD Model** can sometimes play a role in practice. Some tax treaties, for example, provide for different methods to avoid double taxation depending on which allocation rule applies.

327 ***Example:*** *An interior architect, resident in Austria, derives income from designing houses in Liechtenstein. For the purpose of performing his activities, he has a fixed base in Vaduz. Under Art. 14 Austria–Liechtenstein DTC, the income shall be taxable in Austria and in Liechtenstein, but in the latter state only as much as is attributable to the fixed base. Under Art. 23(1) of the DTC between Austria and Liechtenstein, Austria has to exempt the income, which may be taxed in Liechtenstein. If the Austria–Liechtenstein DTC would not contain a provision modelled after the former Art. 14 OECD Model, Art. 7 OECD Model would apply. In that case, Art. 23(2) of the DTC would apply and Austria would only have to credit the tax paid in Liechtenstein.*

328 The differentiation of independent personal services from employment income of Art. 15 OECD Model is more important. The legal consequences set out in Art. 15 OECD Model differ from those in former Art. 14 OECD Model. In the OECD Model, neither a definition of independence nor an explanation of dependence is found. On the basis of the structure of the allocation rules (cf. m.no. 173), however, these concepts exclude each other. In the literature it is assumed that

“entrepreneurial risk” and **“relationship of subordination”** are critical to the distinction between these two concepts (in detail Vogel, *DTC* Art. 15, m.no. 16a).

329 ***Example:*** *An individual working in Canada was found to be a resident of the United States for the purposes of the Canada–US DTC. The tax authorities argued that since he was an employee, the provisions of Art. XV of the DTC allowed Canada to tax the employment income. The taxpayer argued that since he was providing independent personal services, Art. XIV applied instead. In allowing the taxpayer’s appeal, the Federal Court of Appeal took the following factors into consideration: the level of control exercised over the taxpayer’s activities, the ownership of equipment necessary to perform the work, whether the taxpayer hired his own helpers, and the degree of financial risk and profit that was assumed by the taxpayer (CA, FCA 15 Mar. 2002, Wolf v. Her Majesty the Queen).*

8.2 Allocation of taxing rights

330 According to former Art. 14 OECD Model, income from independent personal services can only be taxed in the **residence state of the recipient**. Under former Art. 14(1) OECD Model, an exception arises when the recipient has a fixed base regularly available to him in the other contracting state for the purpose of performing his activities. If there is no fixed base in the other state, however, former Art. 14(1) OECD Model assigns the exclusive right to tax to the residence state of the recipient. In this case, Art. 23 OECD Model does not need to be applied.

331 ***Example:*** *A Dutch tax adviser accompanies his client to Belgium and takes part in contract negotiations. As long as a fixed base in Belgium is not constituted, Belgium does not have the right to tax the adviser’s income. The sole taxing right under Art. 14 of the Belgium–Netherlands DTC belongs to the Netherlands. The method article does not have to be applied in this case.*

332 If the recipient of the income has a fixed base regularly available to him in the other contracting state, former Art. 14(1) OECD Model provides that the **state of the fixed base** also has the right to tax. This state, however, may only tax the income attributable to the fixed base. Former Art. 14(1) OECD Model does not prevent the residence state from taxing the income, too. Art. 23 OECD Model will determine whether the residence state can also tax and credit the taxes paid in the state of the fixed base, or whether the residence state is required to exempt the income (with progression).

333 ***Example:*** *A Bulgarian lawyer has a branch in Ukraine. In addition, he receives interest payments from Ukrainian bank deposits. Art. 11 of the Bulgaria–Ukraine DTC could be applied with respect to these interest payments. Since, however, independent personal services are performed in Ukraine through a fixed base, Art. 11 of that DTC cannot be applied if the interest payments are attributable to the fixed base (Art. 11(3) (PE proviso)). If this is the case, Art. 14 of the Bulgaria–Ukraine DTC is the decisive allocation rule. As long*

as the profits are attributable to the fixed base, they can be taxed in Ukraine. Bulgaria will exempt the income but has the right to apply the progression clause according to Art. 24 of the Bulgaria–Ukraine DTC (Art. 23 OECD Model).

334 The **concept of the fixed base** is important for the allocation of taxing rights. This concept is not defined in the OECD Model. The OECD Commentary on Art. 7, however, points out the parallels between former Art. 14 and Art. 7 OECD Model. From those parallels, it can be concluded that the PE definition of Art. 5 OECD Model can be applied for the interpretation of the fixed base concept.

335 ***Example:*** *An Italian lawyer has an office in Brussels. The exclusive purpose of this office is to obtain the latest information from the institutions of the European Commission and to supply this information to the office in Rome (Italy), where it is used for business purposes. Under Art. 5(3)(e) of the Belgium–Italy DTC, a PE is deemed not to include a fixed place of business used solely for the supply of information. If the understanding of that concept is transferred to the term "fixed base", Belgium does not have the right to tax the profits attributable to the office in Brussels. These profits can therefore only be taxed in Italy.*

336 The PE concept and the fixed base concept are **similar** but not identical. In the literature, it is pointed out that the PE concept is also shaped by the peculiarities of entrepreneurial activity. In this respect, the definition cannot be carried over to the interpretation of the fixed base concept of the former Art. 14 OECD Model (in detail, cf. Vogel, *DTC* Art. 14, m.no. 22 et seq.; cf. also Baker, *DTC* 14 B.08). This results in a wide range of unsolved questions.

337 ***Example:*** *If a self-employed architect carries out business abroad in the course of construction work during a time period exceeding 12 months, he does not constitute a fixed base (according to Vogel, DTC Art. 14, m.no. 26). Art. 5(3) OECD Model is a special provision for the field of PEs. The provision cannot be transferred to a self-employed person involved in this construction work. In my opinion, however, it is difficult to justify treating a builder, falling under Art. 7 OECD Model, differently from an architect, who often undertakes similar tasks.*

338 In practice, the arm's length principle contained in Art. 7(2) OECD Model applies with respect to the **attribution of profits** to fixed bases. Thus, the income of the fixed base, in principle, should also be determined by means of the direct method (cf. m.no. 262 et seq.). However, this assumes separate accounts of the fixed bases. In practice, therefore, the indirect method, i.e. the division of total profits, is of greater importance (Vogel, *DTC* Art. 14, m.no. 28).

339 Contrary to the OECD Model, Art. 14 still forms part of the **UN Model**. When comparing Art. 14(1) of the UN Model with former Art. 14(1) of the OECD Model, it can be said that under the UN Model, there are more situations leading to taxation in the source state than under the OECD Model. The taxing right of

the source state hinges not only on a fixed base regularly available to the tax-payer but also arises when the taxpayer stays in that state for more than 183 days within a 12-month period (for the 183-days rule, cf. m.no. 344).

9. Income from employment

9.1 Income from employment

Art. 15 OECD Model regulates income from employment. This concept is not defined in Art. 15 OECD Model. Its content can therefore be derived from the distinction drawn between employment income and business profits of Art. 7 OECD Model (cf. m.no. 238 et seq.) or independent personal services of the former Art. 14 OECD Model (cf. m.no. 322 et seq.), respectively. The relationship of subordination and the lack of entrepreneurial risk play a role (Vogel, *DTC* Art. 15, m.no. 16a). **340**

According to Art. 15(1) OECD Model, the allocation rules of Art. 16, Art. 18 and Art. 19 OECD Model take **precedence** over Art. 15 OECD Model. This means that directors' fees (Art. 16 OECD Model), pensions (Art. 18 OECD Model) and income from government service (Art. 19 OECD Model) do not fall within the scope of Art. 15 OECD Model. This also applies with respect to income from the activities of artistes or sportsmen (Art. 17 OECD Model). **341**

Example: *Severance payments that help employees during the transition to another job fall under Art. 15 OECD Model because they are based on employment relationships (Vogel, DTC Art. 15, m.no. 10). If the severance pay is granted in lieu of a pension, however, it should be treated as a pension. Art. 18 OECD Model should apply, giving the residence state the sole right to tax (GE, BFH 27 Jan. 1972).* **342**

9.2 Allocation of taxing rights

Art. 15 OECD Model attributes the exclusive taxing right to the residence state of the recipient. If, however, the employment is exercised in the other contracting state, the state of activity also has a right to tax. The rule therefore relies upon the **principle of the place of work**. Whether in these cases the residence state also has the right to tax depends on Art. 23 OECD Model. **343**

An essential exception to the principle of the place of work is set out in Art. 15(2) OECD Model. According to this provision, the residence state will have the exclusive right to tax when the employment is exercised in the other contracting state and the following three requirements are met: the recipient of the income is not present in the other contracting state for more than **183 days** within a 12-month period, the remuneration is paid by an employer or on behalf of an employer that is not resident in the state of activity, and the remuneration is not borne by a PE or a fixed base that the employer has in the state of activity. Art. 15(2) OECD Model is only applicable if all three conditions are met. If any **344**

of these three conditions is not fulfilled, the state of activity has a right to tax according to the general rule of Art. 15(1) OECD Model.

345 ***Example:*** *An employee of a Pakistani company works at a holiday exhibition in Turkey for 1 week. The employee works in Turkey only for this week and during the rest of the year he works in Pakistan. Under Art. 15(2) of the Pakistan–Turkey DTC, only Pakistan has the right to tax the income of the employee during that week. The Pakistani employee is present in Turkey for a period not exceeding 183 days in the calendar year concerned and is paid by a Pakistani company that has no PE in Turkey. If the employee were employed by a Turkish company, Art. 15(2) of the Pakistan–Turkey DTC would be inapplicable. As the state of activity, Turkey would then have the right to tax the employment income of the Pakistani resident.*

346 The 183-days period is **calculated** on the basis of days of physical presence. The OECD Commentary on Art. 15 states that holidays are regularly included in the calculation, if they are spent in the state of activity. The 1992 OECD Model specified that the period has to be calculated as the aggregate of 183 days in any 12-month period commencing or ending in the fiscal year concerned. In this respect, the wording and content of the rule has changed compared to Art. 15(2)(a) OECD Model 1963 and 1977; under the former wording of the OECD Model, the 183-days period was to be calculated separately for every calendar year.

347 ***Example:*** *A person resident in China works in Greece for a Chinese employer from 5 Jul. X0 to 25 Jun. X1. The Chinese employer does not have a PE in Greece, which bears the remuneration of the employee. Art. 15(2) of the China–Greece DTC does not apply because the employee is present for more than 183 days within a 12-months period. The state of activity, Greece, and the residence state, China, have taxing rights for that income in the years X0 and X1. If the wording of Art. 15(2) of the China–Greece DTC did not follow the 1992 OECD Model but an earlier version, the taxing rights would have been allocated differently. Since the employee would not have exceeded 183 days of presence in Greece in either calendar year, the exception to the place of work principle would apply: although he would have been active in Greece for nearly 1 year in total, China would have the sole taxing right.*

348 Art. 15(2) OECD Model is only applicable if the **employer is not resident in the state of activity**. Thus, Art. 15(2) OECD Model also applies if the employer is resident in a third country.

349 ***Example:*** *A taxable person resident in Portugal works for a Spanish company in France. The Spanish employer does not have a PE in France. Art. 16(2) of the France–Portugal DTC (Art. 15(2) OECD Model) is applicable. The residence of the employer in a third state (Spain) does not change the legal situation.*

350 The OECD Model does not contain special rules for **frontier workers**; consequently, these persons are covered by the general provisions of Art. 15 OECD

Model. However, a few European DTCs provide specific provisions for frontier workers. These regulations are not identical but in principle resemble each other: if income from employment is derived by a person who is resident in one state and has his/her place of employment in the other state and returns to the residence state daily, the income is taxable only in the residence state.

351 ***Example:*** *A person is employed by a French bank and is resident in Freiburg (Germany). He commutes every day from Freiburg to Colmar (France) and returns to Freiburg in the evening. Under Art. 13 of the France–Germany DTC (not corresponding with any article of the OECD Model), income from employment derived by persons who work in the frontier zone of one of the contracting states and have their permanent homes in the frontier zone of the other contracting state, to which they generally return each day, shall be taxable only in that other state. Art. 13(b) France–Germany DTC provides that the frontier zone of each of the contracting states shall include municipalities with territories that are, wholly or partly, not more than 20km away from the frontier. Therefore, Germany has the right to tax the income from employment and France does not have any taxing right.*

10. Directors’ fees

10.1 Directors’ fees

352 **Art. 16 OECD Model** covers directors’ fees and similar remuneration that a person receives in his/her capacity as a “member of a board of directors”. This concept is not defined in the convention but according to prevailing opinion it refers to supervisory activities. Income from management activities is therefore not covered by Art. 16 OECD Model. It needs to be taken into account, that the terms used in the OECD Model (“member of a board of directors” and “membre du conseil d’administration ou de surveillance d’une société”) have a broader understanding than the (unofficial) German version of Art. 16 OECD Model (“Aufsichts- und Verwaltungsrat”) (cf. Vogel, *DTC* Art. 16, m.no. 7 et seq.).

353 ***Example:*** *A German resident taxpayer is a member of the board of management of a German company and in this regard receives income from employment. In the taxable year in question he is seconded to a Spanish subsidiary for a total of 124 days and he fulfils several tasks: he acts as a member of the subsidiary’s supervisory board, as the representative of the group management and he is in charge of the subsidiary’s reorganization. Approximately 40% of his total working time is dedicated to the activities conducted for the subsidiary. The taxpayer is remunerated by the parent company for both his activities carried out for the subsidiary and for the parent. In this regard, the German Federal Tax Court held that Art. 16 of the Germany–Spain DTC did*

not apply because this provision only covers remuneration paid specifically for the participation in one of the bodies mentioned therein (i.e. the "Aufsichtsrat" or the "Verwaltungsrat"). Remuneration that is paid in respect of various activities, however, cannot be split up and attributed proportionately to Art. 16 of the Germany–Spain DTC (GE, BFH 23 Feb. 2005, I R 46/03).

354 **Art. 16 UN Model** deviates from the OECD Model as it has a second paragraph covering remuneration paid to top-level managerial positions. The wording "top-level managerial position" indicates that persons occupied with supervising activities, as well as persons performing management activities, fall within the scope of the provision.

10.2 Allocation of taxing rights

355 Under Art. 16 OECD Model, the taxing right is attributed to the **residence state of the company** for which the person receiving the remuneration serves as a member of the board of directors. Whether the residence state of the recipient can also levy taxes is determined by Art. 23 OECD Model. Art. 16 OECD Model, however, only applies if the recipient of the income is resident in one contracting state and the company is resident in the other contracting state. If the company is resident in the recipient's residence state, Art. 16 OECD Model is not applicable. The same holds true for situations in which the company is resident in a third country. In these cases, the residence state has the right to tax according to Art. 21 OECD Model. As regards the allocation of taxing rights, both paragraphs of the UN Model follow the OECD Model.

356 ***Example:*** *A member of the board of directors of an Indian company is resident in Russia. Under Art. 16 of the India–Russia DTC, since the place of effective management of the company is India, India has the right to tax the board member. The Indian taxes paid have to be credited against Russian taxes (Art. 23(1) and (3) of the India–Russia DTC).*

11. Artistes and sportsmen

11.1 Artistes and sportsmen

357 **Art. 17 OECD Model** regulates the income of entertainers, such as theatre, motion picture, radio or television artistes and musicians, and of sportsmen. The concepts are not defined in the OECD Model. However, from the examples provided it can be concluded that artistes in terms of Art. 17 OECD Model can only be persons appearing or reciting in public. Consequently, income generated by artistes not performing in public, such as painters, sculptors, authors or composers, is not covered by Art. 17 OECD Model. The OECD Commentary interprets the concept of sportsman in a broader sense: Art. 17 OECD Model applies not only to athletes in the classic sense, but also to golfers and jockeys (cf. OECD Commentary on Art. 1, para. 5). Activities from the field of entertainment, such as

billiards, chess or bridge, are also regarded as sport activities. For the application of Art. 17, however, an appearance in public is necessary (cf. Vogel, *DTC* Art. 17, m.no. 13a).

358 ***Example:*** *A Czech tennis player earns income in the United Kingdom from tennis tournaments as well as from giving private lessons. The income from the tournament can be taxed in the United Kingdom pursuant to Art. 17 of the Czech Republic–UK DTC. The income from the tennis lessons is not covered by Art. 17 of that treaty since they are not related to a public performance. The United Kingdom's right to tax this income depends on other allocation rules. If the tennis player is providing independent personal services, the United Kingdom may tax the income if he has a fixed base available to him under the provisions of Art. 14 (Art. 14 of the former OECD Model). If the tennis player is providing these lessons under a contract of employment, Art. 15 of the DTC (Art. 15 OECD Model) applies to determine whether the United Kingdom may tax the income.*

11.2 Allocation of taxing rights

359 Under Art. 17(1) OECD Model, the **state of activity** has the right to tax the income. This rule applies regardless of whether the artiste or the sportsman performs as an employee or independently. A PE or a fixed base is not required. The residence state's right to tax is governed by Art. 23 OECD Model.

360 ***Example:*** *A musician resident in China performs in a concert in India. Under Art. 17 of the China–India DTC, China has the right to tax the income, irrespective of whether the musician performed as an employee or independently. A PE or fixed base is also not required. Art. 23(1)(a) of the China–India DTC (method article) provides that the tax payable in India will be credited against the tax payable in China. However, if the musician's performance is part of a plan of cultural exchange agreed upon by the governments, China will have no taxation right (Art. 17(3) of the China–India DTC).*

361 Art. 17(2) stipulates a **"look-through approach"**: if the income does not accrue to the artiste or sportsman himself but to another person, the state of activity of the artiste can tax the income from an activity personally performed by the artiste or sportsman. If, for example, the artiste is employed by a company, Art. 7 OECD Model or Art. 14 of the former OECD Model, not Art. 17 OECD Model, would normally apply with respect to the income generated by the company. Under these general rules, the taxation in the state of activity would depend on the existence of a PE or a fixed base to which the income of the artiste would be attributable. If no such PE or fixed base existed, the state of activity would have no right to tax. Art. 17(2) OECD Model guarantees the right to tax in these cases. The former version of the OECD Commentary on Art. 17 assumed that this rule should only apply in cases of tax avoidance (in cases of so-called "artiste-companies", where an artiste "hires" another person (company) and transfers the right

to provide the artiste's services, cf. Baker, *DTC* 17 B.06), but since 1992, the OECD Commentary opines that Art. 17(2) OECD Model should apply independently from the existence of abuse. However, the wording of Art. 17(2) OECD Model has never contained any grounds that would justify restricting the application of this rule to pure cases of abuse.

362 ***Example:*** *An artiste resident in New Zealand plans to perform in Ireland. For this purpose he establishes a corporation. The artiste is the only shareholder of that corporation. The New Zealand corporation agrees to provide the services of the artiste to perform in Ireland and the fee is paid to the corporation. If Art. 9 of the Ireland–New Zealand DTC (Art. 7 OECD Model) is applied, Ireland would only have the right to tax the fee if the corporation had a PE in Ireland. However, Art. 19(1) and (2) of the Ireland–New Zealand DTC (Art. 17(2) OECD Model) guarantee, based on the "look-through approach", that Ireland can tax the artiste's income.*

12. Pensions

12.1 Pensions

363 Pensions are covered by **Art. 18 OECD Model**. This rule regulates pensions and similar remuneration paid to a person resident in a contracting state with respect to former employment. These payments, which are received during the person's retirement, must primarily serve the maintenance of the person (though not exclusively) (Vogel, *DTC* Art. 18, m.no. 11 with further references). Moreover, the employment needs to be "past" (cf. Baker, *DTC* 18 B.04). Art. 18 OECD Model consequently only covers pension payments made in consideration of past private employment. If the payments result from a former independent personal service, they do not fall under Art. 18 OECD Model. The rule also contains its own reservation in favour of Art. 19(2) OECD Model: pensions paid for government services do not fall under Art. 18 OECD Model. In addition to pensions, **Art. 18 UN Model** explicitly mentions payments made under a public scheme that forms part of the social security system of a contracting state.

364 **Example:** *An employee resident in Singapore has worked for a Dutch company for nearly 25 years – 5 years in the Netherlands, the rest of the time outside of the Netherlands. During his employment he contributed to the employer's pension plan. When he decides to retire he requests to redeem his pension rights related to his employment outside of the Netherlands. The request is granted and the taxpayer receives a lump sum on which withholding taxes are imposed. The question is whether the Netherlands retains its taxing right under Art. 18 of the Netherlands–Singapore DTC. In this regard, the Dutch Supreme Court ruled that such rights were also covered by the term "other similar remuneration" and, consequently, in the case at hand, Singapore, as the residence state, had the exclusive taxing right (NL, HR 5 Sept. 2003, Case No. 37.657).*

12.2 Allocation of taxing rights

365 Under **Art. 18 OECD Model**, the residence state of the recipient has the exclusive right to tax; the state making the pension payment, the former state of activity, cannot tax. There is therefore no need to apply Art. 23.

366 ***Example:*** *A managerial employee resident in Hungary was employed by a Hungarian company. After his retirement, he moved to Portugal and now receives a pension in Portugal. Portugal has the exclusive taxation right under Art. 18 of the Hungary–Portugal DT and, therefore, Hungary cannot tax the pension income.*

367 The **UN Model** offers two alternatives regarding the allocation of taxing rights. Both alternatives have in common that in respect of social security payments, the "state of the fund principle" is applied (cf. also Art. 19(1)(a) OECD/UN Model). Apart from that, Art. 18A UN Model is identical with Art. 18 OECD Model, whereas Art. 18 (2)B UN Model provides for a limited taxation right of the source state if the payments are made by a resident of the source state or a PE situated therein.

13. Government service

13.1 Government service

368 **Art. 19 OECD Model** regulates salaries, wages and other similar remuneration paid by a contracting state, or by a political subdivision or a local authority thereof, to an individual in respect of services rendered to that state or subdivision or authority. Consequently, the income must be paid by the state itself or by a political subdivision. If the payments are made by other public corporations, Art. 19 OECD Model is inapplicable. Furthermore, the words "salaries, wages and other similar remuneration" suggest that these payments would then be categorized as income from employment (cf. Vogel, *DTC* Art. 19, m.no. 3a).

369 ***Example:*** *An Argentinian consulting firm provides services to the Brazilian government for the recruitment of a highway construction company. The consulting firm works for the Brazilian government on the basis of a service contract. Art. 19 of the Argentina–Brazil DTC cannot be applied. The Argentinian consulting firm's income must be attributed to Art. 7 of the Argentina–Brazil DTC. The Brazilian taxing right depends on the existence of a PE.*

370 Art. 19 OECD Model also covers government **pensions** ("pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof"). If these pension payments are made to individuals for services performed for the state or its subdivision or authority, they fall under Art. 19(2) OECD Model. This rule consequently takes precedence over Art. 18 OECD Model, which would otherwise be decisive for pensions.

371 Salaries, wages, pensions and other similar remuneration for services received in the context of the exercise of a **business activity of a contracting state or one**

of its regional corporations are not covered by Art. 19 OECD Model. Art. 19(3) OECD Model clarifies that this income is to be taxed according to the rules for employment (Art. 15 OECD Model), directors' fees (Art. 16 OECD Model), artistes and sportsmen (Art. 17 OECD Model) or pensions (Art. 18 OECD Model). The background for this rule is the goal of neutrality with respect to competition: if public authorities provide services that a private company could also provide, the employee should also be taxed as though he had provided his services to a private company. For this reason, the general rules and not the special provisions of Art. 19 OECD Model should be applied.

372 ***Example:*** *A Spanish resident is employed by a printshop that is operated by a French municipality. The employee works in a PE of this printshop in France and receives his remuneration from the French territorial authority. The France–Spain DTC provides in Art. 19(3) that Art. 19 does not apply because Art. 15 of that DTC applies to remuneration paid in respect of services rendered in connection with a business carried on by a territorial authority of a contracting state. Both states have rights to tax the income. Double taxation is avoided by the application of the method article in Art. 24 of the France–Spain DTC (Art. 23 OECD Model).*

13.2 Allocation of taxing rights

373 The basis for Art. 19 OECD Model is the **"state of the fund principle"**. This is clearly expressed in Art. 19(1)(a) OECD Model: the salary, wage or other similar remuneration may only be taxed by the state for which or for whose subdivisions or authorities the services are provided. One contracting state is thereby prevented from indirectly taxing the other contracting state. Under Art. 19(1)(a) OECD Model, the state of activity has no right to tax and Art. 23 OECD Model is not required.

374 Under certain conditions, however, Art. 19(1)(b) OECD Model allocates the exclusive right to tax to the **state of activity**. This is the case when the recipient of the income is resident in the state of activity. In addition, the recipient of the income must either be a citizen of this state or in any case must not have become a resident of this state exclusively in order to perform services there. This exception overrules the state of the fund principle and grants the state of activity the exclusive right to tax.

375 ***Example:*** *The Saudi Arabian foreign ministry engages a citizen of Pakistan who resides in Saudi Arabia. The employee's job is to explain Saudi Arabian history to visitors of a museum in Pakistan. Saudi Arabia is the "state of the fund". Under Art. 19(1)(b) of the Pakistan–Saudi Arabia DTC, however, Pakistan has the exclusive taxing right because the recipient of the income is resident in Pakistan, renders his services in Pakistan and is a citizen of Pakistan. Therefore, Saudi Arabia cannot tax the income.*

376 The state of the fund principle also applies to **pensions**. Pursuant to Art. 19(2)(a) OECD Model, the contracting state making pension payments to a former employee has the exclusive right to tax these payments. The state of the fund principle is

overruled if the recipient of the income is both resident in the other contracting state and a citizen of the other state.

377 ***Example:*** *A university professor at an Algerian state-run university is resident in Algeria and has both Algerian and Spanish citizenship. After his retirement, he gives up his Algerian residence and moves to Spain. The retirement pension that he receives from Algeria is only subject to tax in Spain since he is only a resident of Spain and has Spanish citizenship (Art. 18(2)(b) of the Algeria–Spain DTC, corresponding to Art. 19(2)(b) OECD Model).*

14. Students

14.1 Payments to students and business apprentices for their maintenance, education or training

378 **Art. 20 OECD Model** covers payments that a student or business apprentice receives for maintenance, education or training. It applies to a student or business apprentice who is or was, immediately before visiting a contracting state, a resident of the other contracting state and who is present in the first-mentioned state solely for the purpose of his or her education or training.

379 The category of persons to which this provision applies is not defined; however, the main **purpose** of the person's presence in the host state must be education or training. In addition, the student or business apprentice might also perform other employment activities on the condition that the main purpose of the stay still remains education or training. Art. 20 OECD Model exclusively deals with payments for these purposes. These payments can also be employment income.

14.2 Allocation of taxing rights

380 Art. 20 OECD Model does not allocate taxing rights to the source state but rather **prevents the host state from taxation** (cf. also Baker, *DTC* 20 B.01). It is required that the person is present in the host country. The legal consequences therefore come into effect independently from the residence of the person even though Art. 1 OECD Model implies for the application of the convention that the person must be resident in either of the two contracting states. According to the wording of Art. 20, the student or business apprentice does not need to be resident in neither of the two contracting states. It is possible that the recipient of the payments remains resident in the other contracting state or that he or she becomes resident in the host country during the studies, provided he or she was resident in the first-mentioned state directly before the entry. Moreover, if a person changes residence to a third country at the time of starting the training or education in the host country, Art. 20 OECD Model is applicable even though the other allocation rules are not. Furthermore, students who have previously changed their primary residence to a third country but maintained another residence in their former state

of residence are covered by Art. 20. Only payments from sources outside of the host country are covered. Payments from sources within the host country can be taxed there (cf. Vogel, *DTC* Art. 20, m.no. 16).

381 According to some DTCs, this rule also applies to **professors, researchers and teachers**, provided they are only temporarily present in the host country and that such persons are, or immediately before their stay were, resident in the other contracting state.

382 ***Example:*** *An Italian university professor is a guest professor at a Dutch university. For this teaching activity, Art. 20 of the Italy–Netherlands DTC provides that he is not taxable in the Netherlands, provided that he is present in the Netherlands solely for the purpose of teaching and that he does not stay in the Netherlands for a period exceeding 2 years. In addition, he must either remain an Italian resident or must have been resident in Italy before he started to work as a guest professor in the Netherlands. If the university professor ceases to be a resident of Italy, he must become a Dutch resident to be covered by the Italy–Netherlands DTC. Otherwise, Art. 1 and therefore Art. 20 of the Italy–Netherlands DTC are inapplicable.*

15. Other Income

15.1 The concept of "other income"

383 The term "other income" is not defined in the OECD Model. **Art. 21 OECD Model** does not set out an exhaustive list of types of income but rather provides a general rule relating to income not dealt with in the foregoing articles (blanket clause). As long as the DTC covers the person and the respective taxes, the income must be categorized according to one of the allocation rules (cf. m.no. 167 et seq.). If no other allocation rule is applicable, Art. 21 OECD Model should be consulted (for a detailed discussion on Art. 21 OECD Model, cf. Rust, in Lang/Pistone/Schuch/Staringer (eds.), *Source versus Residence*, 359 et seq.).

384 ***Example:*** *The beneficiary of a private trust is resident in a DTC state. Since there are no shares in a private trust, no dividends are distributed and the income is not covered by Art. 10 OECD Model. Accordingly, only Art. 21 OECD Model is applicable (cf. more detailed m.no. 277 et seq.).*

385 Art. 21 OECD Model not only covers those sources of income that do not fall under one of the allocation rules of the OECD Model but also applies to income that would normally be covered by another allocation rule that is, however, inapplicable because the conditions are not fulfilled, e.g. income arising in third states.

386 ***Example:*** *An individual resident in Spain holds shares of a corporation that has its seat in Algeria and its place of effective management in Spain. One would think that the dividends received from this participation would be covered by Art. 10(3) of the Algeria–Spain DTC because the term "dividends"*

as used in Art. 10 includes income from shares. However, Art. 10(1) of the Algeria–Spain DTC is inapplicable. The residence state of the corporation distributing the dividends is, under Art. 4(3) of the Algeria–Spain DTC, the state in which the place of effective management is situated. Since both the recipient of the dividends and the paying corporation are resident in Spain, Art. 10(1) of the Algeria–Spain DTC does not apply. Thus, Art. 21 of the Algeria–Spain DTC applies to the dividend payments and Spain has the sole right to tax the dividend income.

15.2 Allocation of taxing rights

387 Under Art. 21(1) OECD Model, the **residence state** has the exclusive right to tax. Since the provisions of this article prevent the other contracting state from taxing, the method article does not need to be applied. Art. 21(2) OECD Model contains a PE proviso stating that income, other than income from immovable property, effectively connected with a PE in the source state is governed by Art. 7 OECD Model.

388 **Art 21 UN Model** contains a third paragraph, which stipulates that income originating from the source state not explicitly dealt with in the earlier articles of the treaty, can also be taxed in the source state. Art. 23 UN Model then determines how the residence state has to avoid double taxation. Nevertheless, income that is not attributable to the earlier articles of the treaty and which is derived from the residence state or third states, shall only be taxable in the residence state.

16. Taxation of capital

16.1 Capital

389 There is only one allocation rule for the **imposition of capital taxes**. Art. 22 OECD Model, however, contains several paragraphs. These paragraphs contain sub-allocation rules. The structure of the article is similar to that of Art. 13 OECD Model (capital gains), except that Art. 13 OECD Model has an additional paragraph (cf. m.no. 316).

390 On the contrary, concerning the **UN Model**, the Group of Experts decided to leave it to bilateral negotiations whether an article on the taxation of capital should be included in a DTC.

391 **Art. 22 OECD Model** is connected to Art. 2 OECD Model. This latter rule specifies that the OECD Model applies to all capital taxes. When the scope of the OECD Model is fulfilled, the taxed capital is to be assigned to one of the sub-allocation rules of Art. 22 OECD Model. Like Art. 13(5) OECD Model (capital gains) and Art. 21 OECD Model (for income taxes in general), Art. 22 OECD Model contains a **blanket clause**. It can be found in Art. 22(4) OECD Model. Capital that cannot be classified under an allocation rule of Art. 22 OECD Model is to be assigned to Art. 22(4) OECD Model.

392 ***Example:*** *A person resident in State A owns land in State B. Both countries levy capital taxes in respect of the property. Under Art. 22(2) OECD Model, the situs principle applies and the country where the property is situated has the taxing right. The residence state has to allow for a credit for the taxes paid in the source state or exempt the capital from the tax base.*

16.2 Allocation of taxing rights

393 **Immovable property** is covered by Art. 22(1) OECD Model. The provision refers to Art. 6 OECD Model. It is always applicable if a person is resident in one contracting state and the immovable property is situated in the other contracting state. In this case, the situs state has the right to tax. Whether the residence state can also tax depends on the method article. The residence state will credit the taxes paid in the situs state if it is entitled to levy taxes. Otherwise, it must exempt the capital (with progression).

394 Movable property forming part of the **business property** of a PE is governed by Art. 22(2) OECD Model. This allocation rule uses the concepts contained in Art. 7 OECD Model. Consequently, the rules of Art. 7 OECD Model must be taken into account for interpreting the rules in Art. 22(2) OECD Model. That provision applies if the property is business property of a PE and the PE is situated in a state other than the residence state of the property's owner. The PE state has the right to tax. The method article regulates whether the residence state is entitled to tax and credit the taxes of the PE state, or whether the residence state must exempt the capital (with progression).

395 Art. 22(3) OECD Model applies to **ships and aircraft** operated in international traffic and **boats** engaged in inland waterways transport, as well as to movable property pertaining to the operation of such ships, aircraft and boats. There is a clear connection to Art. 8 OECD Model. The state in which the place of effective management of the enterprise is situated has the exclusive right to tax. The other contracting state's taxing right is thereby excluded and the method article does not need to be applied.

396 Art. 22(4) OECD Model is the **blanket clause**. All property not covered by Art. 22(1), (2) or (3) OECD Model falls under this rule. For example, it applies to immovable property situated in the residence state or in a third country. It also applies to business property not attributable to a PE in the other contracting state, such as business property of a PE situated in the residence state or in a third country. Above all, however, Art. 22(4) OECD Model covers private capital, which is otherwise not covered by Art. 22 OECD Model. Under Art. 22(4) OECD Model, the owner's residence state has the exclusive right to tax. Once again, the method article does not need to be applied.

397 ***Example:*** *An individual is resident for domestic tax law purposes both in Norway and in Switzerland. The tiebreaker rule of Art. 4(2) Norway–Switzerland DTC leads to Norway being the residence state for treaty purposes.*

The person holds shares in a Norwegian company – as private property. On this type of capital Norway levies a net wealth tax and also in Switzerland a cantonal capital tax is levied. Consequently, double taxation arises, which is countered by Art. 22(4) of the treaty; Norway as being the residence state is allocated the exclusive right to tax.

X. Methods for elimination of double taxation

1. The importance of the method article

1.1 Relation to the allocation rules

398 The methods for elimination of double taxation are set out as rules in **Art. 23A and/or B** of the DTCs patterned after the OECD Model. Under the allocation rules, the residence state's taxing rights are rarely excluded and the source state often keeps its taxing rights as well. The method articles address the residence state. When the residence state's taxing rights are not excluded and a certain item of income may be taxed in the source state, the provision obliges the residence state to either exempt the income or credit the tax paid in the source state.

399 ***Example:*** *A German resident company carries on its activity in part through a PE situated in Spain. Under Art. 7 of the Germany–Spain DTC, profits that are attributable to that PE may be taxed by Spain. Germany's taxing rights with respect to those profits are not excluded by Art. 7 Germany–Spain DTC. Those profits may not be taxed, however, in Germany, according to Art. 23 of the Germany–Spain DTC, since the exemption method applies with respect to that item of income.*

400 The application of the method articles is not always necessary. In some cases, double taxation is avoided by the **allocation rules** themselves, namely when the allocation rules assign exclusive taxing rights to one state.

401 ***Example:*** *The profits derived by the above German resident company are profits from the operation of ships or aircraft in international traffic. The place of effective management of the company is situated in Germany. Under Art. 8 of the Germany–Spain DTC, profits from the operation of ships or aircraft in international traffic shall be taxable only in Germany, notwithstanding the fact that a PE exists in Spain. Spain's taxing rights are therefore excluded by Art. 8 of the Germany–Spain DTC. The application of Art. 23 of that DTC is thus unnecessary.*

1.2 Credit and exemption method

402 Art. 23 OECD Model offers contracting states a choice between two methods for the elimination of double taxation: the **exemption method** and the **credit method**. During the negotiations of a DTC, the contracting states agree on the method they will apply.

403 **Anglo-American countries** prefer the **credit method** (cf. m.no. 179 and 432 et seq.). In **continental European countries**, the **exemption method** (cf. m.no. 177 and 413 et seq.) is widespread, though the **credit method** is usually applied with respect to **dividends, interest payments and royalties**.

404 Under some DTCs, **different methods** apply depending on the residence state, i.e. on whether the person is a resident of one or of the other state. For ex-

ample, under some DTCs, the credit method is applicable as far as residents of one contracting state are concerned, while the exemption method is applicable with respect to residents of the other contracting state.

405 ***Example:*** *Under Art. 23 of the Belgium–Japan DTC, different methods to avoid double taxation apply depending on whether the taxpayer is resident in Japan or in Belgium. Art. 23(1) states that Japan has to grant a credit in respect of Belgian tax payable, whereas Art. 23(2) regulates that in Belgium for certain sources of income the credit method applies and for other sources of income the exemption method is used.*

1.3 Switch-over clauses

406 Some states include **switch-over clauses** in their DTCs to allow a change from the exemption to the credit method in certain circumstances. The aim of these clauses is essentially to avoid double non-taxation, which can arise when the exemption method applies. These clauses can also apply in cases of abuse. Under the switch-over clauses, the residence state retains the right to apply the credit method instead of the exemption method, provided that certain conditions are fulfilled. This change of method can apply, for example, in cases of negative conflicts of qualification, i.e. circumstances in which double non-taxation arises as a consequence of the application of different provisions of the DTC to the same fact pattern by the two contracting states (cf. also m.no. 122).

407 ***Example:*** *Under Sec. 6(c) of the Protocol to the Germany–India DTC, Germany shall avoid double taxation through the credit method and not through the exemption method where "income is placed under differing provisions ... or attributed to different persons", this conflict cannot be resolved by means of a mutual agreement procedure and this placement or attribution would either result in double taxation or in non-taxation, or inappropriately low taxation in India.*

408 **Art. 23A(4)**, added in 2000 to the OECD Model, should generally have an effect similar to switch-over clauses as far as negative conflicts of qualification are concerned, i.e. to give the residence state the right to switch from the exemption method to the credit method where different interpretations of the DTC lead to double non-taxation or to the imposition of low taxes because of Art. 10(2) or Art. 11(2) OECD Model on dividends and interest. It is worth noting that the OECD Committee on Fiscal Affairs maintains that cases of negative conflicts of qualification are partially covered by paragraph 1 of Art. 23A (and of 23B) OECD Model. In particular, according to the OECD Committee, Art. 23(1) OECD Model allows a state to address negative conflicts of qualification which arise due to differences in the domestic law between the source state and the residence state, and Art. 23A(4) only covers negative conflicts of qualification that arise as a result of disagreements between the residence state and the source state on the facts of a case or on the interpretation of the provisions of the DTC. This approach is questionable,

however, from a legal perspective (cf. m.no. 122 et seq.). In the **UN Model**, no provision equivalent to Art. 23A(4) OECD Model is yet included.

1.4 No effect of the method articles

409 The rules regarding the methods for the elimination of double taxation do not apply if, under the domestic law of the two contracting states of a certain DTC, the income is attributed to two different taxable persons, each of whom is a resident of a contracting state. DTCs do not provide any autonomous rules with respect to the **attribution of income** but rather follow the classification of the contracting states. Cases of double taxation have thus to be accepted if two states attribute the income to different persons.

410 ***Example:*** *In the case UK, SCITD 19 Nov. 2008, Bayfine UK Products v. Revenue and Customs Commissioners (cf. m.no. 12) the income of a UK unlimited company was taxable both in the United Kingdom in the hands of the UK unlimited company itself and in the United States in the hands of the parent company of the UK unlimited company, since the latter was classified as a disregarded entity for US income tax purposes. The income of the UK unlimited company was thus attributed to different persons by the two states. The United Kingdom stated that double taxation relief is not to be granted to the UK unlimited company under the UK–US DTC. The OECD Partnership Report (Example 18) proposes that the United States is obliged to give credit for the taxes that are levied in the United Kingdom. However, in my opinion, the OECD Model does not grant an indirect tax credit and there is no systematic argument to ignore the treaty principles in such a situation (cf. Lang, Partnerships, 95 et seq.).*

411 Cases of double taxation may also arise when two contracting states **impose tax on the same person but with regard to different situations**. This can lead to double taxation that is not always prevented by DTCs.

412 ***Example:*** *In 1999, a resident of State A bought shares in the amount of EUR 100 in a company that does not own immovable property. The person moved from State A to State B in 2007, when the shares had a value of EUR 1,000. The difference of EUR 900 was subject to an exit tax in State A, i.e. it was subject to tax in State A because the person lost her status as a resident of that state. State A claimed its right to tax according to Art. 21 OECD Model since it was the residence state at the time of the transfer of residence. If the person sells the shares in 2009 at EUR 1,000, State B has the exclusive right to tax according to Art. 13(5) of the State A–State B DTC patterned after the OECD Model. State B may therefore tax the gain, i.e. EUR 900.*

2. Exemption method

2.1 Effects

413 The exemption method has effects on the level of the **taxable base** in the residence state. The foreign income in respect of which a resident must be granted the ex-

emption under the relevant DTC, is excluded from the taxable base. The applicable tax rate is not affected. The residence state may therefore consider the "exempt" foreign income when determining the applicable tax rates in order to safeguard the progression of the taxation.

414 The exemption method guarantees that an entrepreneur investing abroad is subject to the same tax burden as a competitor resident in the country in which the investment is made ("capital import neutrality"). No taxation accrues in the residence state (although the exempt income may be considered to safeguard the progression of the taxation; cf. m.no. 423 et seq.). The **tax rate of the source state** is therefore decisive.

415 ***Example:*** *In the residence state the tax rate is 40%. In the source state the tax rate is 30%. If the exemption method applies and the taxing rights of the source state are not limited by any allocation rule, the income from a capital investment is subject to a 30% tax burden in the source state and is not subject to any taxation in the residence state. The residence state, however, may consider that income to determine the applicable tax rate. In contrast to the credit method, the overall tax rate on the income from the capital investment is not increased to 40%.*

416 The exemption method applies irrespective of whether the other contracting state actually levies a tax on the income in question. The exemption method can therefore lead to double non-taxation when the source state has taxing rights under the DTC but does not levy any tax under its domestic law, and the residence state has no taxing rights (apart from the progression safeguard) since it must grant the exemption under Art. 23(1) OECD Model. The OECD Partnership Report, however, has led to an amendment of the OECD Commentary on Art. 23 with respect to cases where double non-taxation arises because of **conflicts of qualification**, which result from different domestic laws of the two contracting states, i.e. cases where the domestic laws of the two contracting states lead to different characterizations of a certain income and, in turn, to the application of different allocation rules by the two states. According to the amended OECD Commentary on Art. 23, in those cases the residence state is not required to exempt the income pursuant to Art. 23(1) OECD Model. The possibility for the residence state not to grant the exemption is, according to that statement, the consequence of the fact that the source state legitimately does not allocate the income to the same allocation rule as the residence state. It is, however, not convincing to infer this interpretation from DTCs patterned after the OECD Model (cf. m.no. 122 et seq.)

417 If the DTC contains a **"subject-to-tax clause"**, the exemption will depend on whether taxes are levied in the source state. The OECD Model does not contain such a rule. Subject-to-tax clauses, however, are often found in DTCs. They are usually applicable to particular fact patterns but can also be of a general nature.

418 ***Example:*** *On 17 Oct. 2007 the German Federal Tax Court issued its decision in a case regarding the subject-to-tax clause contained in the DTC between*

Germany and Italy (GE, BFH 17 Oct. 2007, I R 96/06). Subject to certain exceptions, Art. 24(3) of that DTC (Art. 23A OECD Model) provides for an exemption of the income that a German resident derives from Italy and that may be taxed in Italy under the DTC. However, Sec. 16(d) of the Protocol to the DTC reads as follows: "For the purposes of Article 24(3) income of a resident of a Contracting State is deemed to be derived from the other Contracting State, if it is effectively taxed in the other Contracting State in accordance with the treaty." In the case at issue, a capital gain which might be taxed in Italy was not effectively taxed in Italy. The German Federal Tax Court ruled that Sec. 16(d) of the Protocol to the DTC had to be interpreted as a subject-to-tax clause and, consequently, the gain was not to be exempt from German tax under Art. 24(3) of the DTC.

2.2 Exemption from tax base

419 One debated issue is whether the exemption method applies with respect to both positive and negative items (**profits and losses**) or whether it applies only with respect to positive items (i.e. **to profits only**). In this regard, the courts of many states (e.g. Austria, Belgium, the Netherlands and Spain) have stated that the exemption only applies with regard to positive items, while the courts of other states (e.g. Germany, Greece and France) have instead maintained that it also applies with regard to negative items.

420 ***Example:*** *An individual entrepreneur is a resident of Germany and carries on his activity in part through a place of business in Poland. The German profits of the individual entrepreneur amount to EUR 10 million. Through the place of business in Poland, however, the entrepreneur suffers losses of EUR 1 million. His worldwide income consequently amounts to EUR 9 million. According to the interpretation of the German courts, the Polish losses are "exempt" from tax in Germany, i.e. they are excluded from the German resident's taxable base. Thus, the amount of income on which the tax is levied in Germany is EUR 10 million. Under the approach adopted by the courts of other states, the Polish losses should not be "exempt" from tax in Germany, so that the resident's taxable base would be EUR 9 million.*

421 Related to the question of the exemption of losses is the question of the **deductibility of the expenses** paid in order to obtain certain income that is exempt under the applicable DTC (cf. also m.no. 47). Controversy often arises in relation to the allocation rule to which expenses should be assigned, since frequently a connection with several allocation rules exists. For example, certain expenses can be connected to either dividends (Art. 10 OECD Model) or capital gains (Art. 13 OECD Model). Expenses that can be assigned to more than one allocation rule are related to both items of income covered by those rules and no criterion exists to split those expenses between the two items of income. It thus makes sense to consider that these expenses are covered by Art. 7 or Art. 21 OECD Model. Since

these allocation rules grant exclusive taxing rights to the residence state, the expenses are not exempt in the residence state under treaty law and therefore may reduce the resident's taxable base.

422 ***Example:*** *Under Art. 11(3)(a) of the Bangladesh–Turkey DTC, interest from Turkish bonds paid to the Bangladesh Bank shall be exempt from Turkish withholding tax (10%). However, capital gains from the sale of those bonds shall be taxable only in the state of which the alienator is a resident according to 13(4) of the Bangladesh–Turkey DTC. If the purchase of the bonds is financed through borrowing, the question is whether the outbound financing costs should be added to the interest on the bonds (which is exempt from Turkish withholding tax) or to the capital gain from the sale of the bonds (which is taxable only in Bangladesh). Assigning those expenses to one or the other allocation rule affects the availability of a deduction from the Bangladesh resident's taxable base.*

2.3 Progression

423 Arts. 23A(3) and 23B(2) OECD Model contain a rule concerning progression (known as "proviso safeguarding progression"). According to the proviso safeguarding progression, where, in accordance with any provision of the DTC, income derived or capital owned by a resident of a contracting state is exempt from tax in that state, that state may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital. This rule does **not provide itself a legal basis** for the application of progression. It merely clarifies that domestic rules on the determination of the applicable tax rate which aim to safeguard the progression of taxation are unaffected by Art. 23 OECD Model (cf. Vogel, *DTC* Art. 23, m.no. 69 et seq. and 208 et seq.).

424 According to the OECD Model, the proviso safeguarding progression is **addressed to the residence state**. It can therefore be inferred that only the residence state can claim the progression. Implicitly, therefore, the application of progression rules by a contracting state that is not the residence state is arguably excluded (cf. Djanani/Hartmann, *IStR* 2000, 321 et seq.). However, there are also court decisions in some countries, e.g. Germany, that state that the proviso safeguard progression also addresses the source state because the provision only clarifies that it can be applied by the contracting states (cf. GE, BFH 19 Dec. 2001, I R 63/00; GE, BFH 15 May 2002, I R 40/01; GE, BFH 17 Dec. 2003, I R 14/02; GE, BFH 4 Apr. 2007, I R 110/05; partly discussed in Mössner, *IStR* 2002, 242; Kippenberg, *IStR* 2002, 243; Wassermeyer, *IStR* 2002, 289 et seq.; cf. also Vogel, *DBA* Art. 23, m.no. 41, 213 et seq.).

425 ***Example:*** *A US citizen employed by a US company is seconded to a German subsidiary. He receives several payments with respect to this employment. After a certain period of time following his secondment, he becomes a resident of*

Germany. In his German tax return he reports part of those payments as exempt income, since they were derived before he became a resident of Germany and were taxable exclusively in the United States under the Germany–US DTC. Moreover, since under the tiebreaker rule included in the Germany–US DTC, he is deemed to be a resident of the United States only for the purposes of the DTC, he considers that the progression clause applicable with respect to German residents for the purposes of determining the German tax rate is not applicable to his case. The German tax authorities, however, take the position that the German tax rate must be determined according to the progression clause, since the US citizen is a resident of Germany under German domestic law. Therefore, the German tax authorities argue that the exempt payments had to be taken into account for the purposes of the progression clause. With respect to this case, the Finanzgericht Düsseldorf (3rd Senate), in its judgment on the case GE, FG Düsseldorf 31 Jan. 2006, 3 K 846/03, first made clear that the proviso safeguarding progression included in the Germany–US DTC does not grant itself the application of a progression mechanism. Second, the court stated that the proviso safeguarding progression included in the Germany–US DTC merely allows the application of domestic law rules that safeguard the progression, the application of which is a matter of domestic law. The correctness of this conclusion, however, is questionable from a legal standpoint, since the application of progression rules by a contracting state that is not the residence state is arguably excluded.

426 The **effect of the proviso safeguarding progression** is that income that is exempt under the DTC may be included in the resident's taxable base for the purposes of determining the tax rate. The calculation of the tax rate is regulated by domestic law. Normally, the average tax rate applicable is determined with respect to the resident's entire income. This average tax rate is then applied to the resident's taxable base, as reduced after the deduction of the income that is exempt under the DTC. Accordingly, the exemption with progression method does not cause the additional effect that the reduction of the resident's taxable base also reduces the tax rate applicable to the resident's residual income.

427 ***Example:*** *The worldwide income of a resident of State A amounts to EUR 1 million. Under the State A–State B DTC, profits amounting to EUR 500,000 are exempt in State A. The remaining taxable base is EUR 500,000. The average tax rate applicable on total income amounting to EUR 500,000 is, for example, 41,75%. The average tax rate applicable on a total income amounting to EUR 1 million is, for example, 49%. The progression clause in State A's domestic law, the application of which is allowed under the State A–State B DTC, determines that the average tax rate that is applicable on total income amounting to EUR 1 million (49%) applies on the remaining taxable base (EUR 500,000). Hence, the tax levied in State A is EUR 245,000 rather than EUR 208,750.*

428 The average tax rate may not be applied, however, to that part of income that is subject to a reduced or increased flat tax rate under a specific domestic provision in the residence state. These peculiarities have to be taken into account when **determining the taxable base** in respect of which the average tax rate has to be applied. In addition, deductible items have to be taken into account in calculating the taxable base in connection with those items of income for which these expenses are paid or incurred. If the deductible items are paid in connection with exempt income, they cannot decrease the residual domestic taxable base. It is different if the deductible items are clearly connected with items of income that form part of the residual domestic taxable base (cf. m.no. 421 et seq.).

429 ***Example:*** *A resident of Austria receives income from employment exercised in Austria and derives business profits through a PE situated in Germany. Insofar as income from employment is subject to a 6% flat tax rate, it must be excluded from the taxable base to which the average tax rate determined according to the progression clause is applied. In other words, the average tax rate determined by including income that is exempt under the Austria–Germany DTC (business profits derived through a PE situated in Germany) should be applied to income from employment. Yet that income has to be excluded from the taxable base to which the average tax rate has to be applied. Therefore, income from employment remains subject to a 6% flat tax rate.*

430 Progression does not usually play any role with regard to the **corporate income tax** since the tax rate is usually flat. The average tax rate always remains the same. This also holds true in the case of negative progression. However, if the amount of foreign losses corresponds to the amount of domestic source income at such a rate that the worldwide income is zero, one could argue that the average corporate tax rate is 0%. This statement, however is questionable from a legal standpoint (cf. Vogel, *DTC* Art. 23, m.no. 214 et seq.).

431 ***Example:*** *A company resident in the Slovak Republic has one PE in Bratislava and one in Milan. Each of the two PEs obtains profits amounting to EUR 1 million. The Slovak taxable base amounts to EUR 1 million since exemption of the Italian business profits must be granted pursuant to Art. 23(2)(a) Italy–Slovak Republic DTC. Since the tax rate that is applicable to companies is flat (19%), the tax rate on EUR 1 million income is equal to that on EUR 2 million income. The flat tax rate of 19% is thus applicable with respect to the Slovak taxable base amounting to EUR 1 million. The tax amounts to EUR 190,000.*

3. Credit method

3.1 Effects

432 When the credit method is applied, the residence state first determines the tax due under domestic law on the resident's worldwide income in the absence of the DTC. This tax is then reduced by the foreign tax paid. The credit method has

therefore no effect on the taxable base in the residence state. Positive and negative foreign items are ordinarily taken into account in the calculation of the taxable base. Double taxation is avoided only with respect to the amount of tax levied. If the tax rate is higher in the residence state than in the source state, the total tax burden will be equivalent to the **higher rate found in the residence state**. This phenomenon is known as "capital export neutrality".

433 ***Example:*** *In the source state profits are taxed at an average tax rate of 20%. Thus, if the source state income is EUR 100, the tax burden in the source state is EUR 20. If, however, the average tax rate is 50% in the residence state, taxes in the amount of EUR 50 arise. These taxes are reduced by EUR 20, representing the taxes paid in the source state, and thus equal EUR 30. The overall tax burden, however, amounts to EUR 50.*

434 If the source state has a higher tax rate than the residence state, the **higher tax burden of the source state** remains when the ordinary credit method applies. The taxable base is determined in the residence state under domestic law, the tax is then calculated and the foreign taxes are deducted from that amount of tax. If, however, the tax rate is higher in the source state, the tax paid in the source state is not entirely credited. The overall tax burden corresponds in this case to the tax burden in the source state.

435 ***Example:*** *In the source state the tax rate is 50% whereas the tax rate is only 20% in the residence state. In the source state income in the amount of EUR 100 will be subject to a tax burden of EUR 50. When the credit method is applied, the income is also subject to tax in the residence state. On the basis of the tax rate in this contracting state, the tax burden is EUR 20. Foreign taxes in the amount of EUR 20 can be credited on the taxes of EUR 20, so that there is no actual tax burden in the residence state. However, the total tax burden, given the taxation in the source state, is EUR 50.*

436 The credit method applies only with respect to foreign taxes paid by the same taxable person. A credit for the taxes paid by a different taxable person, such as the "underlying tax credit" (also known as **"indirect tax credit"**), is not granted unless the particular DTC or the domestic law provides otherwise.

437 ***Example:*** *Company U is a resident of the United Kingdom and controls 50% of the voting power in Company A, a resident of Argentina. According to UK domestic law and to Art. 23(1)(b) Argentina–UK DTC, in cases in which at least 10% of the voting power is controlled, a tax credit shall be granted by the United Kingdom with regard to dividends, not only with respect to Argentinian tax levied in Argentina on Company U with regard to such dividends but also with respect to Argentinian tax paid by Company A with respect to the profits out of which such dividends are paid ("underlying tax").*

438 Similar problems arise when, under the domestic legal systems of the two contracting states, a certain item of **income** is regarded as **belonging to two different taxable persons**. In these cases, in my view, there is no legal basis

under the DTC for claiming a credit, since the tax is levied in the source state on a different taxable person than that on which the tax is levied in the residence state.

439 ***Example:*** *An Austrian corporation holds a participation in a foreign corporation, which is regarded as a taxable subject under Austrian law and under the applicable foreign law. According to Sec. 42 InvFG (law applicable to investment funds), the profits of the foreign corporation are treated as belonging to the Austrian shareholder. Even if the relevant OECD-patterned DTC provided for the credit method, it would not provide any legal basis for the view that a tax credit must be granted to the Austrian shareholder with regard to the foreign corporate tax that is levied in the foreign state on the profits of the foreign corporation.*

3.2 Amount of allowable tax

440 The credit method provides for the taxes paid in the source state to **offset the taxes** to be paid in the residence state. However, only the amount of tax that is legally due in the source state is covered. Taxes erroneously paid to the source state are not required to be credited. Furthermore, taxes raised in the source state in excess of the limits set forth in the DTC do not have to be credited. If the source state does not refund the taxes erroneously paid, the taxpayer suffers the consequences.

441 ***Example:*** *In 2007, an Italian resident company rendered services in Kazakhstan for a 7-month period. A withholding tax was levied in Kazakhstan on the payments to the Italian company. The Italian resident company asked the Italian tax authorities to issue a ruling to state that a tax credit was to be granted with respect to the taxes levied in Kazakhstan. The Italian tax authorities, however, denied the right for the Italian resident company to the tax credit (cf. IT, AE 3 Jul. 2008, Risoluzione N.277/E). They analysed the Italy–Kazakhstan DTC and found that business profits of Italian resident companies may be taxed in Kazakhstan to the extent they are attributable to a PE situated therein. They also found that for a PE to exist under the Italy–Kazakhstan DTC, services have to be rendered for a period of at least 12 months. The Italian tax authorities therefore concluded that no PE existed in Kazakhstan according to the relevant DTC and, accordingly, tax could not be levied in Kazakhstan on business profits of the Italian resident company. Consequently, they stated that no tax credit was to be granted to the Italian resident company, which should instead ask Kazakhstan for a refund of the tax paid therein.*

442 The creditable taxes are limited to those which are **effectively levied**. If the source state levies an amount of tax that is lower than the maximum amount allowed under the DTC, the credit to be granted by the residence state is limited to the amount of tax effectively levied in the source state.

443 ***Example:*** *A Spanish resident company holds a 5% participation in an Italian resident corporation. In 2009, dividends were paid by the Italian corporation.*

The Spanish company was the beneficial owner of those dividends. Under Art. 10(2) of the Italy–Spain DTC, a maximum of 15% withholding tax may be levied in Italy. However, only a 1.375% withholding tax was actually levied in Italy. According to Art. 22 of the Italy–Spain DTC, the credit method applies. Since the creditable taxes are limited to those which are effectively levied, Spain was obliged to grant a credit amounting to 1.375% of the dividends, even though the maximum withholding tax that may be levied in Italy was higher.

444 Some DTCs include exceptions to the above principle. In particular, a **"matching credit"** is sometimes granted under DTCs concluded with developing countries. Under this kind of credit method, a notional amount of foreign taxes established in the relevant allocation rule or in the method article is deemed to be levied at source and is credited by the residence state even if the tax is not actually levied in the source state or a lower amount of tax is levied. This provision is intended to stimulate capital investments in the developing country. The matching credit prevents the residence state from benefiting, in place of the investor, from the non-taxation or reduced taxation by the source state: in the absence of a matching credit mechanism, the residence state would simply credit less foreign tax and would therefore frustrate the non-taxation or reduced taxation by the source state. Under the matching credit, the benefit goes to the investor, since the residence state grants a credit on a notional basis irrespective of the amount of taxes paid in the source state. The investor obtains the advantage.

445 ***Example:*** *A French company derives interest arising in Brazil. Under the Brazil–France DTC, this interest may be taxed in Brazil. According to Art. XXII(2)(c) of the Brazil–France DTC, with regard to interest which has borne Brazilian tax in accordance with the provisions of the DTC, France shall allow its residents receiving such income a tax credit corresponding to the amount of Brazilian tax that has been paid, within the limits which the French tax establishes in such income. Under Art. XII(2)(d) of the Brazil–France DTC, with regard to interest, the Brazilian tax shall be considered to have been levied at a minimum rate of 20%. The French company deriving interest arising in Brazil is thus entitled to a tax credit corresponding to at least 20% of the interest, irrespective of whether lower tax is actually levied in Brazil.*

446 Some DTCs provide for another kind of credit method based on notional amounts, which is known as a **"tax sparing credit"**. Under the tax sparing credit, when an exemption or reduction is granted in the source state, the residence state grants a credit on the basis of the (fictitious) amount of foreign taxes, which the source state would levy if no exemption or reduction were granted.

447 ***Example:*** *A Belgian company derives interest arising in India. This interest may be taxed in India under the Belgium–India DTC. According to Art. 23(3)(b)(i) of the Belgium–India DTC, when a resident of Belgium derives interest taxable in India in accordance with Art. 11(2) or (6), the Indian tax levied on*

that income shall be allowed as a credit against Belgian tax related to such income. Art. 23(3)(e) of the Belgium–India DTC also provides that: "For the purposes of sub-paragraph (b)(i) the term 'Indian tax levied' shall be deemed to include any amount which would have been payable as Indian tax under the laws of India and in accordance with the provisions of the Agreement for any year ...", except for some exemptions or reductions listed in that provision of the DTC. Based on the above, the Belgian company deriving interest from India is entitled to a tax credit for the amount of taxes that would have been payable as Indian tax, even if no taxes are actually levied in India (unless the non-taxation in India is grounded on those exemptions or reductions that are listed in the Belgium–India DTC).

3.3 Maximum credit

448 DTCs generally set forth a **maximum credit** that must be granted. The amount of tax which must be credited may not exceed the tax that the resident would pay in the residence state on the same (foreign) item of income. This is known as "ordinary credit." This means that in order for a credit to be granted, a tax on the same (foreign) item of income must first of all be due in the residence state. If no tax is due in the residence state in the same tax period, the tax paid in the source state is not credited. According to the OECD Commentary on Art. 23A and 23B (at para. 32.8), when the lack of tax due in the residence state is the consequence of a timing mismatch, the residence state must nonetheless grant the credit.

449 ***Example:*** *A US corporation derives business profits from a PE in the United States and receives royalties arising in Australia. The royalties amount to USD 5 million. However, the PE suffers losses amounting to USD 5 million as well. Under the Australia–US DTC, the ordinary credit method applies. The taxable base in the United States is USD 0 since the losses suffered through the PE offset the royalties. Therefore, in this fiscal year no tax is due in the United States. Any tax at source which may be raised in Australia in respect of the royalties can consequently not be credited against any US tax.*

450 The maximum credit limitation is usually applied according to one of the following approaches: the "overall limitation" and the "per-country limitation". Under the **"overall limitation"**, the aggregate amount of taxes paid in all source states may be credited up to the amount of tax due in the residence state on the aggregate amount of items of creditable income from all source states. Under the **"per-country limitation"**, the tax paid in a certain source state may be credited up to the amount of tax due in the residence state as determined on the aggregate amount of items of income derived from the former state; items of income derived from other contracting states are thus disregarded. Sometimes a **"per-item limitation"** is implemented in addition to one of the above limitations (the "overall limitation" or the "per-country limitation"). Under the "per-item limitation", the tax paid per a certain category of income may be credited up to the amount of

tax due in the residence state as determined on the aggregate amount of tax paid for a certain category of income.

451 ***Example:*** *Company A is a resident of State A and has a PE in State A and a PE in State B. Company A also derives income from interest arising in State C. In the fiscal year concerned, no profits are derived through the PE in State A; profits amounting to EUR 1 million are derived through the PE in State B, in respect of which a tax of EUR 250,000 is levied (25%); interest amounting to EUR 500,000 arises in State C, in respect of which a tax of EUR 50,000 is levied (10%). Company A's worldwide income amounts to EUR 1.5 million and the tax due in State A on this income amounts to EUR 300,000 (20%). If State A followed the "per-country limitation", the tax credit would be determined as follows. With regard to the tax levied in State B: a tax credit amounting to EUR 200,000 would be granted since the tax due in State A in respect of the profits derived in State B is EUR 200,000 (1 million x (300,000/1.5 million)). With regard to the tax levied in State C: a tax credit amounting to EUR 50,000 would be granted. The total tax credit granted would amount to EUR 250,000, notwithstanding the overall taxes levied abroad amount to EUR 300,000. Hence, taxes amounting to EUR 50,000 would be paid in State A [300,000 (tax due in State A) – 250,000 (tax credit)]. If State A instead followed the "overall limitation", the tax credit would be determined as follows: items of income and foreign taxes would be aggregated. The tax due in State A in respect of all foreign items of income is EUR 300,000. The taxes paid abroad on those items of income amount to EUR 300,000 (250,000 + 50,000). The foreign taxes may thus entirely be credited; hence no tax would have to be paid in State A.*

452 The ordinary credit can create difficulties in practice when high **expenses are linked** to the foreign items of income and the residence state considers the maximum credit to be determined with respect to the amount of the foreign items of income as reduced by those expenses ("net amount"). The tax due in the residence state in respect of the net amount can likely be very low, so that the foreign taxes may largely not be credited. This problem could be resolved by calling the connection of expenses into question.

453 ***Example:*** *An Austrian corporation has a total income of EUR 1 million. Part of this income is interest arising in Italy amounting to EUR 100,000. The Italian loans, from which the interest derives, are financed through borrowing. The capital costs that are connected with this interest amount to EUR 90,000. The net amount of interest arising in Italy is thus, according to the opinion of the tax administration, EUR 10,000. The tax due in Austria in respect of that net amount is EUR 2,500 (25%). However, under the Austria–Italy DTC, Italy may levy a tax on that interest that does not exceed 10% of its gross amount. The Italian tax at source on the interest therefore amounts to EUR 10,000. It may be credited only up to EUR 2,500; hence EUR 7,500 may not be credited.*

XI. The implementation of treaty benefits in both contracting states

1. Source state

DTCs frequently **limit or eliminate the source state's taxing rights**. When the DTC rules are applied, they are equivalent to domestic law. Eliminations or reductions of the taxing rights thus have the same consequences as they do in domestic law: the rules have to be taken into consideration by the taxpayer and the administrative authorities when domestic law is applied. Eliminations or reductions of the taxing rights provided for by a DTC must therefore be applied from the beginning, as if no taxing rights existed. 454

Example: *A Polish corporation pays royalties to a corporation resident in Lebanon. The Lebanese company is the beneficial owner. Under Polish domestic law, royalties paid to non-resident companies are liable to a 20% final withholding tax. According to Art. 12(2) of the Lebanon–Poland DTC, however, Poland's right to tax those royalties is limited to 5%. Consequently, only 5% withholding tax is levied.* 455

Occasionally, a tax limitation contained in a DTC is **not applied**. For example, the full amount of withholding tax is levied in the source state although the relevant DTC eliminates or reduces the source state's taxing rights. This is not a mistake by the taxpayer. Source states often levy the full amount of withholding tax to reduce the risk that, in the event the DTC requirements are not fulfilled, no tax will be withheld. These states grant the taxpayer the possibility of applying for a refund once the DTC requirements have been fulfilled. 456

Example: *In the above example, if in Poland a 20% withholding tax was (by mistake) withheld with regard to the royalties, the Lebanese company would have to apply for a refund of the withholding tax exceeding the 5% stipulated in the DTC.* 457

The ECJ developed its case law on the **principles of equivalence and effectiveness** and therefore requires that these principles are followed by the domestic legislators and administrative authorities. Due to the fact that EC law and tax treaty law are to a certain extent comparable, one can argue that the phrase "irrespective of the remedies provided by the domestic law of those State" in Art. 25(1) OECD Model, seems to apply that **"remedies provided by domestic law"** exist and that they are relevant for the application of tax treaties. One cannot assume that the drafters of the OECD Model had remedies in mind that are not effective. Secondly, one can also argue that the true legal basis for the application of the principles of equivalence and effectiveness in the context of tax treaties is the OECD Model itself and the DTCs following the OECD Model as a whole (cf. Lang, *Intertax* 1997, 146 et seq.). 458

Under the law of some states, specific provisions set forth that the reduction of the withholding tax may be granted **directly at source** rather than through a tax 459

refund procedure. As a rule, such provisions are not part of the DTC. They are instead part of domestic law. In fact, domestic law normally regulates when an immediate tax reduction at source is allowed or when that reduction may only be obtained through a tax refund procedure carried out by the taxpayer.

460 In some cases, the tax authorities of the source state request **evidence of taxation** by the residence state if the taxpayer is seeking a tax exemption on the basis of a DTC. However, this evidence is not necessary in cases in which the DTC grants exclusive taxing rights to the residence state. The effective taxation by the residence state is irrelevant as long as the relevant DTC does not contain a subject-to-tax clause.

2. Residence state

461 In residence states the DTC rules are often **equivalent to domestic law**. An exemption of foreign income as well as a deduction of foreign taxes has to be executed ex officio. No specific request by the taxpayer is necessary, unless the DTC provides otherwise.

462 If, in the residence state, the measures for the avoidance of double taxation are not part of the assessment of the taxpayer, the DTC rules may be applied by the taxpayer or third parties. In particular, a DTC **should be applied directly** if a withholding tax is levied at source and the obligation to credit foreign taxes or to exempt foreign income exists on the basis of the DTC.

463 ***Example:*** *The French corporate tax rate is 33 1/3%. Under Art. XII(2)(d) of the Brazil–France DTC, the amount of credit that has to be granted by France to its residents in respect of interest arising in Brazil is (at least) 20% of that interest (matching credit, cf. m.no. 444 et seq.). Assume a French resident corporation derives interest arising in Brazil. If the DTC could be applied directly, the tax actually levied in France on that interest would amount to 13 1/3%. An immediate advantage for the French corporation would thus ensue.*

3. The importance of the evidence of taxation in the other contracting state

464 The tax authorities of many countries tend to make the application of a tax limitation in a DTC dependent on whether the taxable person provides **evidence that taxes have been levied in the other contracting state**. This way they can test that the relevant DTC is interpreted uniformly compared to the other contracting state and that the same DTC provision is applied. However, there is no legal basis for such a requirement: neither the actual imposition of taxes nor an identical interpretation by the tax authorities is a precondition for the application of OECD-patterned DTCs. Even if this were relevant, the tax authorities would still have the possibility of obtaining information by themselves through the exchange of

information (cf. m.no. 511 et seq.), so that no increased obligation to cooperate can be imposed upon the taxable person. Thus, the existence of evidence of taxation is not a precondition for the application of a DTC.

XII. The arm's length principle of Art. 9 OECD Model

465 Multinational enterprises with affiliates in different tax jurisdictions face the challenge of determining a price for transactions effectuated within their groups of companies. Since the price cannot result from supply and demand in an open market, a **transfer price** has to be established. Besides economic reasons – the assessment of the single entities' profitability and related accounting issues – a transfer price is charged in order to determine the taxable profit of each company in an adequate way. Therefore, for multinational enterprises as well as for tax authorities, the issue of transfer pricing is of utmost importance, especially in the light of global tax planning; by over- or under-pricing intercompany transactions, the profits within the group can be shifted to low-tax jurisdictions and the overall tax burden of the multinational can thereby be minimized.

466 **Art. 9(1) OECD Model** is the basis for DTC provisions relating to transfer pricing: "Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

467 This provision is placed in between the allocation rules. However, Art. 9 OECD Model is not an allocation rule but has a special role. Although this rule has a confining effect similar to that of the allocation rules, it addresses cases of economic double taxation: domestic rules that provide for profit adjustments between affiliated companies must apply the **arm's length principle**. This means that transactions between affiliated companies must be treated as if they had been carried out between two wholly independent parties.

468 DTC rules patterned after Art. 9 OECD Model are not an independent legal basis for the adjustment of profits between affiliated companies. Like every other DTC provision, these rules do not create tax liability. The legal basis can therefore only be found in domestic law. If there is no domestic law allowing for the **adjustment of profits**, there can be no profit adjustment pursuant to Art. 9 OECD Model.

469 ***Example:*** *A Romanian company delivers single components of cars to its parent company, which is resident in Germany, and receives compensation amounting to EUR 100 for each component. If the subsidiary had sold these goods to a third party, a price of EUR 200 for each component could have been realized (arm's length price). Domestic law will determine whether or not the Romanian tax authorities may adjust the profits of the subsidiary. If a*

profit adjustment takes place, Art. 9(1) of the Germany–Romania DTC provides that the transfer price must be set in accordance with the arm's length principle. It is now assumed that Romania adjusts the profit of the subsidiary in accordance with the arm's length principle and adds EUR 100 per component to the profits. This will lead to economic double taxation because the part of the profit that does not meet the arm's length price is also taxed in Germany – at the level of the parent company. In order to avoid this, Art. 9(2) of the Germany–Romania DTC provides for an adjustment in Germany as well, as long as Germany agrees with Romania's adjustment.

470 Since 2001, unlike the OECD Model, the **UN Model** contains a third paragraph in Art. 9. It addresses circumstances under which Art. 9(2) UN Model ("matching adjustment") shall not apply. Therefore, a contracting state is not required to conduct an adjustment where judicial, administrative or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under Art. 9(1) UN Model (identical with Art. 9(2) OECD Model), one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. This provision resembles Art. 8(1) of the EU Arbitration Convention and the necessity of its inclusion can be discussed controversially (in detail Kosters, *Asia-Pacific Tax Bulletin* 2004, 7 et seq.).

471 The OECD has published **Transfer Pricing Guidelines (OECD TPGs)**. These reports are extremely important in practice since they provide an interpretation of the arm's length principle as well as several methods for establishing the arm's length price. However, since the OECD TPGs are recommendations, they are not legally binding principles. If they were available at the time of the conclusion of a particular DTC that is based on the OECD Model, they can be used for the interpretation of that DTC. The OECD TPGs are not, however, an independent legal basis for the adjustment of profits between affiliated companies. As stated above, there must be domestic rules providing for a profit adjustment.

472 The OECD TPGs present several **methods** for establishing the arm's length price. The selection of one method is not easy and may vary from company to company, but, generally, an appropriate method can be found to estimate the arm's length price in the best possible way. One can distinguish the traditional transaction methods (standard methods) and the other methods (transactional profit methods). There is no "best method rule"; the company does not have to test all methods in order to find the best transfer price. However, according to the OECD, the standard methods take precedence over the other methods because they represent the most direct way to calculate the arm's length price.

473 The three **standard methods** are the comparable uncontrolled price (CUP) method, the resale price (RP) method and the cost-plus (CP) method. They all have in common the fact that they are based on principles of business economics. The CUP compares the transaction with "real-life" uncontrolled transactions to

calculate the arm's length price. This is the most precise method but is in most cases inapplicable due to the lack of comparability. The RP method takes into account the price of the product when it is resold on the next supply chain level to a third party and deducts a gross margin in order to calculate the arm's length price. Finally, the CP is very similar to the RP method but proceeds the other way around, i.e. the arm's length price is calculated by adding a mark-up to the company's costs.

474 The **other methods** are only applicable if one of the standard methods does not lead to a reliable arm's length price or if the standard methods cannot be applied at all. The other approaches referred to in the TPGs are the profit split method and the transactional net margin method, both of which are based on a comparison of profit margins between controlled and uncontrolled companies.

475 Establishing the arm's length principle is based on the **comparability** of controlled and uncontrolled situations. According to the OECD TPGs, being "comparable means that none of the differences between the situations being compared could materially affect the condition being examined in the methodology, or that reasonably accurate adjustments can be made to eliminate the effect of any such differences" (OECD TPGs m.no. 1.15). The OECD TPGs (m.no. 1.19-1.35) identify **five factors** determining the comparability: (1) the characteristics of property or services; (2) the functional analysis; (3) the contractual terms; (4) the economic circumstances; and (5) the business strategies. The difference in the characteristics of property and services, such as in respect of the transfer of tangible property, the physical features of the property, the quality and reliability, and the availability and volume of supply, often leads to differences in their value. Moreover, the comparison of the function of the parties is important because in dealings between independent enterprises the compensation reflects the functions taken on by each enterprise. The contractual terms of transactions generally define (explicitly or implicitly) how the responsibilities, risks and benefits are to be divided between enterprises in arm's length dealings. An analysis of the contractual terms should be part of the functional analysis. The arm's length price varies across different markets and it is therefore important to identify the relevant markets and achieve comparability. Some economic circumstances, which determine market comparability, are geographic location, the size of the markets and availability of substitute goods and services. In addition, business strategies are also important to determine the comparability for transfer pricing purposes. Following business strategies are important in determining the comparability of controlled and uncontrolled transactions: innovation, new product development, degree of diversification, risk aversion, assessment of political changes and input of existing and planned labour laws.

476 In 2009, the OECD proposed a **revision** of chapter I-III of the OECD TPGs, based on the experience acquired since 1995 by tax administration and taxpayers. The main changes concern (1) the hierarchy of transfer pricing methods, (2) the

applicability and the performance of the comparability analysis, and (3) the guidance on the application of transactional profit methods. As described above, the OECD TPGs distinguish between two categories of transfer pricing methods. In the previous version, the transactional profit methods have a status of "last resort", which means that they are only used in exceptional cases where there are no other data available at all on the other transactional method. The OECD revised this viewpoint: now the "most appropriate method to the circumstances of the case" has to be selected.

XIII. Non-discrimination

1. Scope of application of non-discrimination rules

477 DTCs also contain non-discrimination rules. Art. 24 is the relevant rule in the OECD Model. It provides certain specific grounds that cannot be relied on by a state to discriminate for purposes of taxation. In relation to nationals of the treaty partner state, **Art. 24 OECD Model** prohibits discrimination by reason of nationality (para. 1) and contains similar protection for stateless persons (para. 2). In relation to residents of the other contracting state, Art. 24 OECD Model prohibits discrimination against PEs belonging to (para. 3), against deductions of certain payments and debts to (para. 4), and against enterprises owned by residents of the other contracting state (para. 5).

478 Art. 24 OECD Model prohibits only overt discrimination which meets the specific criteria of the non-discrimination provisions. These rules are **directly applicable** rules. If domestic law contravenes a non-discrimination rule, the domestic law is ousted when the DTC is applied. The DTC provisions regarding non-discrimination rules have priority.

479 Under Art. 24(6) OECD Model, the non-discrimination rules are **not limited by Art. 2** OECD Model. Consequently, the non-discrimination rules also apply to taxes that are not covered by the scope of the DTC. The non-discrimination rules therefore impact the entire domestic tax law.

2. Non-discrimination on the grounds of nationality

480 Under Art. 24(1) OECD Model, **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 contracting state in the same circumstances (in particular with respect to residence) are or may be subjected. This provision also applies to persons who are not resident in either contracting state.

481 Nationals of one contracting state must therefore be treated like nationals of the other contracting state, provided they are in a **comparable situation**. The rule does not provide grounds upon which discrimination can be justified. However, special reasons can cause the situation of the taxpayer to be incomparable to that of nationals of a contracting state, in which case the non-discrimination rules will not apply.

482 ***Example:*** *A US company had filed requests for reimbursement of German input value added taxes (VAT) for several years. A request of the taxpayer for reimbursement of input tax paid in the period from Oct. until Dec. 2000 was denied on the grounds that the term of 6 months, laid down in the German law on value added tax for making this request had been exceeded. The taxpayer objected against the refusal to grant leave to appeal on the grounds, that the*

German Law on VAT violated the principle of non-discrimination laid down in Art. 24(1) of the Germany–US DTC because it only applies to non-resident taxpayers. The German Federal Tax Court decided that this prohibition only applies to discrimination on the basis of nationality. In the present case, a difference in treatment occurred because of the place of residence of a person. Therefore, the special regulations on the taxation procedure contained in the German law on VAT did not infringe Art. 24(1) of the treaty because they only refer to the place of residence for practical reasons (GE, BFH 8 Apr. 2005, V B 123/03).

483 Art. 24(2) OECD Model enables national treatment to be accorded to **stateless persons**, which means individuals who are not considered to be nationals of any state under the operation of its law. This non-discrimination provision is rarely agreed upon in international tax treaty practice because a very similar rule can be found in the Convention relating to the Status of Stateless Persons concluded in New York in 1954.

3. Non-discrimination on the grounds of the PE of an enterprise

484 Under Art. 24(3) OECD Model, the taxation of a **PE** that an enterprise of a contracting state has in the other contracting state shall not be less favourable in that other contracting state than the taxation levied on enterprises of that other contracting state carrying on the same activities. Art. 24(3) OECD Model expressly states that this provision shall not be construed as obliging a contracting state to grant to residents of the other contracting state any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

485 This non-discrimination rule is, in practice, the most important provision of Art. 24 OECD Model. PEs of persons that are residents in the other contracting state must be **treated like companies that are residents in the PE state**. If the situation is comparable, there can be no discrimination of the PE.

486 ***Example:*** *A US Company held participations of more than 10% in several German companies through its German PE. In its corporate net wealth tax return in 1990 it claimed an exemption for these participations on the basis of Sec. 102 Valuation Act for companies resident in Germany holding similar participations. The German tax administration refused to grant the exemption. The taxpayer appealed to the German Federal Tax Court, arguing that Art. 24(2) of the Germany–US DTC (Art. 24(3) OECD Model) of the treaty compares the taxation of a PE maintained by a US resident in Germany with the taxation of a German enterprise carrying on the same activities. The German Federal Tax Court considered the shares to be part of the PE's assets in Germany without discussing whether there was a functional connection and determined that the taxpayer met the conditions for the exemption of Sec. 102 Valuation Act, except for its not being a resident of Germany. The*

court referred the case to the Court of First Instance in order to determine if and to what extent debts relating to the participations had to be excluded from the PE's assets along with the participations (GE, BFH 10 Mar. 2005, II R 51/03).

4. Non-discrimination according to Art. 24(4) OECD Model

487 Under Art. 24(4) OECD Model, **interest, royalties and other disbursements** that are paid by an enterprise of a contracting state to a resident of the other contracting state, shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned state. The provisions of Arts. 9(1), 11(6) and 12(4) OECD Model have priority over the rule in Art. 24(4) OECD Model. This non-discrimination rule is also applicable in the area of capital taxes.

488 The provision prohibits discrimination on the basis of the **residence of a creditor**: payments made to persons resident in the other contracting state must have the same effect on the domestic tax basis as they would when made to persons that are resident in the state of residence of the creditor. If payments to residents decrease the tax basis of the creditor, payments to non-residents must also decrease the creditor's tax basis.

489 ***Example:*** *A natural person, resident in the United States, pays interest to a resident of Canada. For the purpose of determining the taxable profits of the US resident, the interest must be deductible under the same conditions as if it had been paid to a resident of the United States. Art. 25(7) of the Canada–US DTC does not only apply to enterprises but to all residents. If the DTC would follow the OECD Model, that kind of discrimination would have not been covered.*

5. Non-discrimination in connection with the shareholders/ partners of a company

490 Under Art. 24(5) OECD Model, an enterprise of a contracting state, the capital of which is **wholly or partly owned or controlled, directly or indirectly**, by one or more residents of the other contracting state, shall not be subjected in the first-mentioned state to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned state are, or may be, subjected. This provision prohibits discrimination on the basis of the residence of a shareholder or partner in the other contracting state.

491 ***Example:*** *In 1984, a corporation resident in the United States sold a loan portfolio to its parent company resident in the United Kingdom for a loss. Deduction of the loss in the United States was deferred under US domestic law, which provided that a loss on a sale of property between members of a*

controlled group of companies may not be deducted until the property is disposed of by the purchasing group member. Before the parent company had sold the loan portfolio, the US corporation left the controlled group. Consequently, the loss could not be used and the taxpayer argued that this was a discrimination against companies of foreign ownership, which was forbidden under Art. 24(5) of the UK–US DTC. The US Court of Appeals for the Ninth Circuit, however ruled that the taxpayer was not discriminated against because the taxpayer could not prove that the taxation of British-owned US subsidiaries was "more burdensome" than the taxation of US-owned US subsidiaries. The outcome would have been the same if the UK parent company had been a US company (US, 9th Cir. 18 Sep. 2002, UnionBanCal Corp. v. Commr.).

XIV. Mutual agreement procedure

1. Mutual agreement procedures

DTCs also contain rules dealing with the **legal protection of the taxpayer**. In DTC law, the competent authorities in the two contracting states are responsible for the application of the DTC rules. In practice, it is possible for the authorities of the two contracting states to come up with different conclusions. Even if in both states the assessments are appealed, it is possible that the different interpretations of the same rule will remain since the courts of appeal of the two contracting states can also interpret situations differently. There is a lack of a superior authority. **492**

The rules of the mutual agreement procedure try to cure this deficiency. **Art. 25 OECD Model** contains the mutual agreement procedure. It can be initiated by any resident person who considers that the actions of one or both of the contracting states result or will result for him/her in taxation not in accordance with the provisions of the DTC. The condition is therefore not double taxation but rather taxation not in line with the DTC. Often, mutual agreement procedures are initiated on the basis of economic double taxation (Art. 9 OECD Model). **493**

Example: *A taxable person, resident in Malta, receives interest from United Arab Emirates bonds that are not subject to source taxation under United Arab Emirates domestic law. Under Art. 11(1) of the Malta–United Arab Emirates DTC, Malta does not have the right to tax. If the Maltese tax authorities nevertheless want to tax these earnings because the administration does not consider Art. 11(1) of the Malta–United Arab Emirates DTC to be applicable, the taxable person may present his case to the competent authority of his state of residence. Under Art. 24 of the treaty (Art. 25 OECD Model), the taxpayer may initiate a mutual agreement procedure even though the actions of the Maltese tax authorities would not lead to double taxation but only to the imposition of taxes in Malta.* **494**

For the initiation of the mutual agreement procedure, it is sufficient that the intended **taxation be not in accordance with the DTC**. The taxation does not have to have been already imposed. The taxable person must only be able to assume that taxes will be imposed on his/her income or capital contrary to the DTC. **495**

Example: *On the basis of written communications between the taxpayer and the tax authorities, the taxpayer knows that the tax authorities want to tax income that, in his opinion, is exempt on the basis of the applicable DTC. The taxpayer does not need to wait for an assessment by the tax administration in order to present his case to the tax authorities in his state of residence.* **496**

The taxable person can present his/her case to the competent authority of his/her residence state irrespective of the **remedies provided by domestic law**. A waiver of the legal remedy is not a condition for a mutual agreement procedure. Thus, **497**

the taxpayer has the option of using different remedies side by side. The case must be presented within 3 years from the first notification of the action resulting in taxation not in accordance with the provisions of the DTC.

498 The taxpayer must present the case to the **competent authority of the state in which he/she is a resident**. The DTC defines the competent authorities of the contracting states. A mutual agreement procedure can be initiated only in the residence state. In the case of transfer pricing conflicts between affiliated companies, the mutual agreement procedure can be initiated in both states since each state is a residence state for one of the companies.

499 Under Art. 25(2) OECD Model, the competent authority shall **"endeavour"** to resolve the case by mutual agreement with the competent authority of the other contracting state, with a view to the avoidance of taxation that is not in accordance with the DTC. The objection must appear to the competent authorities to be justified and the competent authority must not itself be able to arrive at a satisfactory solution.

500 Whether the competent authority is **obliged to initiate a mutual agreement procedure** is controversial. However, the representatives are obligated to negotiate and use their best endeavours to resolve the problem. Apart from the taxpayer's right to present objections, the OECD Model does not include provisions that refer to the taxpayer's position in the mutual agreement procedure. According to the OECD Commentary on Art. 25, however, it is the duty of the contracting states to give the taxpayers "certain essential guarantees". "The proper approach is to give the taxpayer the right to a hearing and the possibility to obtain information on how the mutual agreement is proceeding" (cf. Vogel, *DTC* Art. 25, m.no. 81).

501 The duration of the mutual agreement procedure is unregulated. In practice, it can take a long time. There is **no guarantee** that the mutual agreement procedure will result in a mutual agreement between the competent authorities of the two contracting states. Furthermore, the mutual agreement procedure can be discontinued without a solution having been reached. Even if an agreement between the competent authorities is reached, there is no guarantee that the result of the agreement procedure will correspond to the wishes of the taxpayer. One of the key objectives of the OECD is to improve the timeliness of processing and completing MAP cases. Therefore, the OECD publishes on its website annual statistics on the MAP caseloads of all its Member countries and of non-OECD countries that agreed to provide such statistics (cf. http://www.oecd.org/document/7/0,3343,en_2649_37989739_43754119_1_1_1_1,00.html; accessed on 15 Jun. 2010).

502 ***Example:*** *A person resident in Chile earns income that is taxed in both Chile and Ecuador. The taxpayer presents his case to the Chilean competent authority in accordance with Art. 25(1) of the Chile–Ecuador DTC. The competent authorities reach an agreement under the mutual agreement procedure to the effect that the income is taxable only in Chile. Double taxation is thereby*

avoided. The taxpayer, however, may have been of the view that only Ecuador should tax the income. The agreement does not, however, have to accord with the taxpayer's wishes.

The **result of a mutual agreement procedure shall be implemented** notwithstanding any time limits in the domestic law of the contracting states. **503**

2. Consultation procedure

Under Art. 25(3) OECD Model, the competent authorities of the contracting states shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the DTC. This means that the competent authorities can resolve any interpretation problem **irrespective of a case put forward** by a taxpayer. **504**

However, the competent authorities are bound by the DTC; they cannot come to a conclusion that overrides the DTC. Art. 25 OECD Model contains **no legal basis** for a treaty override by the competent authorities. In this respect, the relevance of this rule is limited (cf. especially also m.no. 109 et seq.). **505**

In addition, the competent authorities can discuss the avoidance of double taxation in cases that are **not covered by the DTC**. This rule is not an independent legal basis for the avoidance of double taxation; it does not authorize the competent authorities to avoid cases of double taxation. If the competent authorities reach an agreement, they must utilize the statutory sources of domestic law. **506**

3. Arbitration procedure

The mutual agreement procedure has been found to be unsatisfactory in practice. The legal protection is insufficient for the taxpayer. For this reason, many states have entered into DTCs that contain a **compulsory mutual agreement procedure through arbitration**: if the authorities of the two contracting states cannot reach an agreement within a fixed period of time, the question is referred to an arbitration committee that will then rule on the issue. The arbitral decision is binding on the competent authorities. Some treaties (e.g. France–Germany DTC, Mexico–US DTC), however, contain non-compulsory mutual agreement procedures, which do not solve the problem of insufficient legal protection. **507**

Example: *Art. XXVI (6) of the Canada–US DTC contains a mandatory arbitration clause applicable in cases that the competent authorities have been unable to resolve by mutual agreement. In connection with this DTC, the treaty negotiators agreed to an Arbitration Note. This Arbitration Note provides the practices and procedures that the two countries will follow, including the commencement of the arbitration proceedings and the selection of the arbitration board. In particular, the arbitration board has 6 months to reach a decision on the case and the decision must be one of the two solutions proposed by the contracting states. This is known as "baseball arbitration".* **508**

509 **Art. 25(5) OECD Model**, introduced with the OECD Model Update 2008, will help to improve the unsatisfactory situation in the coming years, when numerous DTCs will contain the proposed regulation. This new provision provides for a mandatory resolution of unresolved mutual agreement procedures. Art. 25(5) OECD Model provides that where the competent authorities, after 2 years of discussions, have not been able to resolve the case, the issues that are preventing them from reaching an accord can, upon request, be submitted to the arbitral process. No procedural requirements have been fixed by Art. 25(5) OECD Model; the competent authorities shall settle the mode of application by mutual agreement. A sample mutual agreement setting out a number of procedural rules is attached as an annex to Art. 25 OECD Model.

510 In contrast to the OECD Model, the UN Model lacks a provision stipulating a compulsory mutual agreement procedure through arbitration. Instead, in **Art. 25(4) UN Model**, the contracting states are requested to develop methodologies in order to implement the mutual agreement procedure. The Commentary on Art. 25 UN Model (at para. 5 et seq.) elaborates on the way these procedures may be designed, especially with respect to the essential rights of the taxpayer and the adjustment of profits between affiliated companies.

XV. Exchange of information

1. Scope of application of the exchange of information

DTCs also contain rules regarding the exchange of information. The decisive rule is **Art. 26 OECD Model**. The rule provides that the competent authorities of the contracting states shall exchange such information as is foreseeably relevant for carrying out the provisions of the applicable DTC or for the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the contracting states, insofar as the taxation thereunder is not contrary to the DTC. According to this "major information clause", the exchange of information can also include information that relates to domestic law and not only to the DTC itself. **511**

Example: *When applying Arts. 15 and 24 of the Australia–Belgium DTC (Arts. 15 and 23 OECD Model), Belgium can inform Australia of the amount of employment income exempt from taxation in Belgium when the employment of a Belgian resident is exercised for more than 183 days in Australia. In addition, Belgium can ask Australia what an independent company in Australia paid for goods delivered by a company in Belgium with a view to the correct application of the provisions of its domestic laws.* **512**

Art. 26 UN Model reproduces Art. 26 OECD Model apart from three additional phrases inserted in para. 1. According to the UN Commentary on Art. 26, the words "in particular for the prevention of fraud or evasion of such taxes" were inserted at the request of members of the Group, mainly from developing countries, who wanted to emphasize that the exchange of information under Art. 26 covers the purpose of preventing fraud or evasion. In particular, the last sentence stipulating that the competent authorities shall develop appropriate conditions, methods and techniques concerning the exchange of necessary information (including, where appropriate, regarding tax avoidance), stresses the importance of the competent authorities in fully implementing the provisions and will give them the necessary authority. **513**

Many DTCs contain only the **"minor information clause"**. Under the "minor information clause", the competent authorities can only exchange information that is necessary for carrying out the DTC. Consequently, information that relates only to a tax liability under domestic law cannot be exchanged. **514**

Example: *The exchange of information for the purpose of splitting the profits between affiliated companies is questionable if a DTC contains only a "minor information clause". This is because the adjustment of profits between affiliated companies can be performed only on the basis of domestic law (cf. m.no. 468). DTC law can only be affected if the DTC has an effect on the profits of the companies. If the information is required to establish, under the DTC, the limits on potential profit adjustments, it involves the application of the DTC. Consequently, the information can be exchanged under the "minor information* **515**

clause". If, however, the information relates not to the limits established under the DTC but to the application of domestic law within those limits, the information relates only to domestic law and therefore cannot be exchanged under the "minor information clause" (cf. Vogel, DTC Art. 26, m.no. 42).

516 The implementation of a "major information clause" or a "minor information clause" **affects the personal scope** of the exchange of information. If the "major information clause" is part of the DTC, residence in one of the two contracting states is not a condition for the application of the exchange of information article by one of the states. This is the result of Art. 26(1) OECD Model, which states that the exchange of information is not restricted by Art. 1 OECD Model. The residence is neither a condition for the enquiry concerning the person who is the subject of the request nor the person for whose assessment the information is required. However, the exchange of information is not permitted for people who are not covered by the DTC if the "minor information clause" applies. In this case, the exchange of information only serves the application of the DTC.

517 The **substantive scope** of the exchange of information under Art. 26 OECD Model includes also all taxes that are not covered by the DTC. Information can therefore be given with respect to all taxes, even if they are not covered under the scope of the DTC (cf. m.no. 222 et seq.).

2. Types of exchange of information

518 There are different forms of information exchange. It is possible to differentiate between the following forms of information exchange:

- an **exchange upon request**: a request for information is made to the other contracting state, having a special case in mind;
- an **automatic exchange** of information: information about one or various categories of income having their source in one contracting state and received in the other contracting state is transmitted systematically to the other contracting state;
- a **spontaneous** exchange of information: exchange of information without request because one state has acquired, through certain investigations, information that it supposes will be of interest to the other state;
- a **simultaneous tax examination**: an agreement between two or more parties to examine simultaneously, each in its own territory, the tax affairs of one or more taxpayers in which they have a common or related interest, with a view to exchanging any relevant information that they obtain;
- a **tax examination abroad**: representatives of one contracting state are authorized to participate in a tax examination taking place within the territory of the other contracting state; and
- an **industry-wide exchange** of information: the exchange of tax information concerning an entire economic sector and not taxpayers in particular.

519 For many years it was rather common to accept an information exchange only upon request. The 1963 OECD Commentary on Art. 26 (at para. 7) held spontaneous information to be inadmissible. The 1977 OECD Commentary on Art. 26, on the contrary, regarded spontaneous information as admissible (at para. 9), although the wording of the OECD Model had not changed in this respect. The current OECD Commentary on Art. 26 provides for the application of all forms of information exchange mentioned above. The Commentary even states that the manner in which the exchange of information agreed to in the DTC will be effected can be **decided upon by the competent authorities** of the contracting states.

3. Limitations on the exchange of information

520 **Art. 26(3) OECD Model** contains various restrictions on the exchange of information. The exchange of information article does not oblige the contracting states to carry out administrative measures at variance with the laws and the administrative practice of either contracting state. In addition, information that cannot be obtained under the law or in the ordinary administrative procedure of this or the other contracting state is not required to be exchanged. The principle of reciprocity is a part of the exchange of information since the requesting contracting state (the "other Contracting State") is subject to these limits. The requested contracting state does not need to provide information that the requesting contracting state could not obtain under its own law or administrative practice. Furthermore, the states do not need to release information that discloses a trade, industry or professional secret or a business practice or that would be contrary to public order ("ordre public").

521 **Art. 26(5) OECD Model**, which was added in 2005, is intended to ensure that the limitations of Art. 26(3) OECD Model cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees and agents and fiduciaries, as well as ownership information. The vast majority of the OECD Member countries have exchanged such information under the previous version of Art. 26 OECD Model and therefore this paragraph mainly reflects current practice. The **UN Model** does not include an article dealing with this matter.

522 In 2009, the OECD and the G-20 leaders agreed that they were ready to take action against jurisdictions that do not meet international standards on tax transparency and do not exchange information effectively (i.e. **"tax havens"**). Most of the countries involved, such as Austria, Belgium, the Cayman Islands, Hong Kong, Liechtenstein, Luxembourg, Singapore and Switzerland, have expressed their willingness for a dialogue on extending international cooperation in taxation issues and have partly already concluded DTC amendments or treaties dealing with exchange of information relating to tax matters.

523 ***Example:*** *An individual resident in Denmark maintains a bank account with a bank in Switzerland. Denmark is examining the income tax return of the*

individual and makes a request to Switzerland for all bank account income and asset information held by the bank in order to determine whether there were deposits of untaxed earned income. In the past, Switzerland refused to provide such bank information to Denmark under its banking secrecy laws, as long as this was not a case involving acts of fraud for which the individual would be subject to imprisonment under the laws of both contracting states. Denmark and Switzerland have signed a protocol to their treaty that now allows exchange of the relevant information needed by Denmark.

4. Competence and obligation of secrecy

524 The competent authorities responsible for the exchange of information are the **supreme tax authorities**, i.e. in most cases the ministry of finance. The competent authorities are obliged to keep information received from the other contracting state **secret**. Under Art. 26(2) OECD Model, any information received by a contracting state shall be treated as secret in the same manner as information obtained under domestic laws of that state. The information shall be disclosed only to persons or authorities concerned with the assessment or collection of, the enforcement or prosecution in respect of the determination of appeals in relation to the taxes referred to in the DTC, or the oversight of the above. Such persons or authorities shall use the information only for these purposes. They may disclose the information in public court proceedings or in judicial decisions.

525 **Art. 26(4) OECD Model** was added in 2005 and deals with the duty to exchange information in situations where the requested information is not needed by the requested state for domestic tax purposes. The new provision clarifies that an exchange of information should be carried out even though the requested state may not need the information for its own tax purposes. Prior to the addition of Art. 26(4) OECD Model, this obligation was not expressly stated in the article but was clearly evidenced by the practice followed by OECD Member countries. Since the **UN Model** was last updated in 2001, it does not contain a provision similar to Art. 26(4) OECD Model.

XVI. Assistance in the collection of taxes

526 In 2002, the OECD Committee on Fiscal Affairs added **Art. 27** to the OECD Model, which provides for assistance in the collection of taxes. The contracting states assist each other in the execution of revenue claims. It remains to be seen if – and how efficiently – Art. 27 OECD Model will be enforced in practice.

527 The administrative assistance covers revenue claims. The term **"revenue claim"** means an amount owed with respect to taxes of every kind and description imposed on behalf of the contracting states or of their political subdivisions or local authorities, including interest, administrative fines, penalties and costs that are linked to the execution or safeguarding of this amount. This is subject to the condition that the taxation is not contrary to the DTC or another agreement concluded between the contracting states. Revenue claims that are enforceable under the laws of a contracting state and are owed by a person who, at that time, cannot, under the laws of that state, prevent its collection, shall, at the request of the competent authority of this state, be accepted for purposes of collection by the competent authority of the other contracting state. These revenue claims shall be collected by that other contracting state in accordance with the provisions of its law applicable to the enforcement and collection of its own taxes as if the revenue claims were revenue claims of that other contracting state.

528 In no case, however, shall the provisions be construed so as to impose on a contracting state the obligation to carry out administrative measures at variance with the laws and administration practice of that or the other contracting state, or to carry out measures which would be contrary to public policy (**"ordre public"**). In addition, administrative assistance is not required to be provided if the other contracting state has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice, or in those cases where the administrative burden for that state is clearly disproportionate to the benefit to be derived by the other contracting state.

529 ***Example:*** *A citizen of the United States, who owes taxes in the United States, moves to Canada. Under Art. XXVIA of the Canada–US DTC (Art. 26 OECD Model), the United States may request that Canada collects the tax due in the United States. The United States will send the request to Canada, certifying that the revenue claim has been finally determined (the taxpayer's appeals have been exhausted). Provided all the conditions are met, the Canadian tax administration will proceed to collect the tax from the individual in the same way as it would if the tax debt were a debt owing to Canada (formal requests, court proceedings and garnishment). If the individual challenges these actions in court, the court cannot consider the validity or correctness of the claim, since it has been finally determined in the United States. It must treat the tax debt as an amount due under the Canadian Income Tax Act, the collection of which is not subject to any restriction. Once these proceedings have*

been concluded and Canada has collected the tax, it will forward the tax to the US competent authority.

530 In the **UN Model**, no article regarding the assistance in the collection of taxes has yet been inserted. However, the UN Committee of Experts on International Cooperation in Tax Matters has accepted a draft reproducing Art. 27 OECD Model, which is supposed to be included in the next update of the UN Model (cf. Vogel, *DBA* Art. 27, m.no. 4).

XVII. Inheritance tax treaties

1. Structure

531 In addition to the OECD Model on income and on capital (hereafter OECD Income Tax Model), there is an OECD model in the field of estate, inheritance and gift taxes (hereafter **OECD Inheritance Tax Model**). It was published in 1966 and modified in 1982 (cf. m.no. 25). Gift taxes were not included in the substantive scope of the model until 1982. In practice, taxes on income and on capital, on the one hand, and estate, inheritance and gift taxes, on the other hand, are regulated by different DTCs. The conclusion of a common DTC remains an exception (e.g. Germany's DTCs with Denmark and Sweden, and many French DTCs).

532 The structure of the existing OECD Inheritance Tax Model is **similar to that of the OECD Income Tax Model**. When the person and the respective taxes are covered by the DTC, one of the allocation rules definitely applies. The method article (Art. 9A or 9B OECD Inheritance Tax Model) will determine whether double taxation is avoided by the credit or the exemption method.

2. Scope of the convention

533 The scope of the OECD Inheritance Tax Model is set out in **Art. 1 and Art. 2**. In contrast to the 1966 version of this model, the 1982 version covers gifts in addition to estates and inheritances. Both the deceased at the time of death and the donor at the time of the gift must be resident in one or both contracting states. Pursuant to Art. 4(1) OECD Inheritance Tax Model, a person is **resident** in a contracting state if the person's estate or gift is liable to tax in that state by reason of the domicile, residence or place of management of that person or any other criterion of a similar nature. The OECD Inheritance Tax Model applies to **taxes** on estates and inheritances, and on gifts (Art. 2(1) OECD Inheritance Tax Model).

534 ***Example:*** *A resident of Belgium owns a summer home in France. When he dies, the house is passed on to his children who live in France. Under the laws of both states, the transfer of property mortis causa is taxable. In Belgium, tax liability arises from the decedent's residency status. In France, tax is levied by reason of the residence of the heirs. Since the decedent was domiciled in Belgium at the time of his death, the Belgium–France Inheritance Tax DTC applies to the inheritance. Art. 1(2) of the treaty covers all taxes imposed by reason of death. Consequently, the heirs can invoke the treaty's allocation rules.*

535 Art. 4(2) and 4(3) OECD Inheritance Tax Model include a **tiebreaker rule** similar to that found in the OECD Income Tax Model (cf. m.no. 211 et seq.). Where a person, at the time of his/her death or of the gift, is a resident of both contracting states, the residence state is determined according to the provisions set forth therein.

536 ***Example:*** *A woman had a permanent home in State A, where she lived with her husband and children. At her death, however, she was staying temporarily in State B to carry out work there. For this purpose she had rented a small apartment. If, under the domestic laws of both states, she is regarded as being domiciled at her death in both states, the tiebreaker rule gives preference to State A because her only permanent home was in that state (cf. OECD Commentary on Art. 4 Inheritance Tax Model, para. 8).*

537 In practice, a number of **deviations** from the OECD Inheritance Tax Model can be found. Many existing inheritance tax treaties – primarily those concluded before 1982 – are not applicable to gift taxes. Some treaties limit the scope to citizens of one of the two contracting states or tie it to tax liability. However, since a majority of OECD Member countries impose comprehensive tax liability if the deceased or the donor was domiciled in their countries, Arts. 1 and 2 OECD Inheritance Tax Model were drafted accordingly.

3. General definitions

538 **Art. 3** OECD Inheritance Tax Model defines the most relevant term for the model: "property which forms part of the estate of, or of a gift made by, a person domiciled in a Contracting State" includes any property the devolution or transfer of which, under the law of a contracting state, is liable to a tax covered by the Convention. Moreover, Art. 3 includes a definition of the term "competent authority".

539 In addition to the definitions in Art. 3 OECD Inheritance Tax Model, the meanings of other **important terms** are explained in other articles. The term "domicile" is defined in Art. 4 OECD Inheritance Tax Model and the terms "immovable property", "PE" and "nationals" are clarified by the respective provisions (cf. OECD Commentary on Art. 3 Inheritance Tax Model, para. 1).

4. Allocation of taxing rights

540 The allocation rules correspond to the allocation rules for the taxation of capital and capital gains in the OECD Income Tax Model. Consequently, there is an independent allocation rule for **immovable property** (Art. 5 OECD Inheritance Tax Model) and for **property of a PE or a fixed base** (Art. 6 OECD Inheritance Tax Model). Art. 7 OECD Inheritance Tax Model is a **blanket clause**.

541 Pursuant to Art. 5 OECD Inheritance Tax Model, **immovable property** can be taxed in the contracting state in which the property is situated. Art. 5(2) OECD Inheritance Tax Model defines immovable property corresponding to Art. 6(2) OECD Income Tax Model (cf. m.no. 230). The order of precedence set forth in Art. 5(3) OECD Inheritance Tax Model guarantees that Art. 5 OECD Inheritance Tax Model also applies to immovable property of an enterprise and to immovable property used for the performance of professional services or other activities of an independent character. Art. 5 OECD Inheritance Tax Model is dominated by

the principle of situs: the situs state also has a taxing right. The method article then determines whether double taxation is avoided by means of the exemption or the credit method.

542 Art. 6 OECD Inheritance Tax Model regulates the imposition of taxes on **movable property** representing business property of a PE of an enterprise forming part of the estate or gift. The PE state has the right to tax. The method article determines whether the residence state can also tax and then credit the taxes paid in the PE state, or whether it must grant an exemption.

543 Art. 7 OECD Inheritance Tax Model is a **blanket clause**. According to this rule, all capital not dealt with in Arts. 5 or 6 may only be taxed in the contracting state in which the deceased or the donor was resident at the time of the transaction.

544 ***Example:*** *An individual primarily domiciled in Switzerland with a secondary residence in Denmark dies. Among the assets he leaves are Danish and Swiss shares. Under Art. 6 of the Denmark–Switzerland Inheritance Tax DTC, the assets not covered by Art. 5 of the treaty are taxable only in the contracting state in which the deceased was resident at the time of death. Since the deceased was domiciled in both contracting states at the time of his death, the tiebreaker rule must be consulted in order to resolve the problem of dual residence. Pursuant to Art. 4(2)(a) of the treaty, the residence state is Switzerland, provided that the deceased's personal and economic relationships were closer to Switzerland than they were to Denmark. Consequently, Switzerland has the exclusive taxing right (all provisions mentioned above correspond to the OECD Inheritance Tax Model).*

5. Special provisions

545 **Arts. 10 to 16 OECD Inheritance Tax Model** contain special provisions similar to the OECD Income Tax Model. There are rules regarding non-discrimination, the mutual agreement procedure, exchange of information, diplomatic agents and consular officers, territorial extension, entry into force and termination.

Annexes

Annex 1:
OECD Model Convention with Respect to Taxes on Income and on Capital

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TITLE OF THE CONVENTION
Convention between (State A) and (State B)
with respect to taxes on income and on capital[1]

PREAMBLE TO THE CONVENTION[2]

CHAPTER I
SCOPE OF THE CONVENTION

Article 1
Persons covered

This Convention shall apply to persons who are residents of one or both of the Contracting States.

Article 2
Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

[1] States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or both the avoidance of double taxation and the prevention of fiscal evasion.

[2] The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:
a) (in State A): ....
b) (in State B): ....

4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

CHAPTER II
DEFINITIONS

Article 3
General definitions

1. For the purposes of this Convention, unless the context otherwise requires:
a) the term “person” includes an individual, a company and any other body of persons;
b) the term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;
c) the term “enterprise” applies to the carrying on of any business;
d) the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
e) the term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
f) the term “competent authority” means:
   (i) (in State A): ....
   (ii) (in State B): ....
g) the term “national”, in relation to a Contracting State, means:
   (i) any individual possessing the nationality or citizenship of that Contracting State; and
   (ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State;

h) the term "business" includes the performance of professional services and of other activities of an independent character.

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 4
Resident

1. 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. 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.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Article 5
Permanent establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

CHAPTER III
TAXATION OF INCOME

Article 6
Income from immovable property

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise.

Article 7 (OECD Model 2008)
Business profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities

under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 7 (OECD Model 2010)
Business profits

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.

4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 8
Shipping, inland waterways transport and air transport

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9
Associated enterprises

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Article 10
Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
b) 15 per cent of the gross amount of the dividends in all other cases.
The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

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

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

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

Article 11
Interest

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 12
Royalties

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13
Capital gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

[Article 14 – Independent personal services]
[Deleted]

Article 15
Income from employment

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16
Directors' fees

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17
Artistes and sportsmen

1. Notwithstanding the provisions of Articles 7 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised.

Article 18
Pensions

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

Article 19
Government service

1. a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect

of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:
   (i) is a national of that State; or
   (ii) did not become a resident of that State solely for the purpose of rendering the services.

2. a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20
Students

Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 21
Other income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively con-

nected with such permanent establishment. In such case the provisions of Article 7 shall apply.

CHAPTER IV
TAXATION OF CAPITAL

Article 22
Capital

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.

3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

CHAPTER V
METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A
Exemption method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that

State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

Article 23 B
Credit method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

CHAPTER VI
SPECIAL PROVISIONS

Article 24
Non-discrimination

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 provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. Stateless persons who are residents of a Contracting State shall not be subjected in either 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 the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 25
Mutual agreement procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. Where,

a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State,

any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.[3]

[3] In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each States concludes that it would be appropriate to do so base on the factors described in paragraph 65 of the Commentary on the paragraph. As mentioned in paragraph 74 of that Commentary, however, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals.

Article 26
Exchange of information

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:
a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

Article 27
Assistance in the collection of taxes[4]

1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

2. The term "revenue claim" as used in this Article means an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.

3. When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.

4. When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the first mentioned State or is owed by a person who has a right to prevent its collection.

5. Notwithstanding the provisions of paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a

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[4] In some countries, national law, policy or administrative considerations may not allow or justify the type of assistance envisaged under this Article or may require that this type of assistance be restricted, e.g. to countries that have similar tax systems or administrations or as to the taxes covered. For that reason, the Article should only be included in the Conventions where each State concluded that, based on the factors described in paragraph 1 of the Commentary on the Article, they can agree to provide assistance in the collection of taxes levied by the other State.

revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.

6. Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.

7. Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be

a) in the case of a request under paragraph 3, a revenue claim of the first-mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or
b) in the case of a request under paragraph 4, a revenue claim of the first-mentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first-mentioned State shall either suspend or withdraw its request.

8. In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to carry out measures which would be contrary to public policy (ordre public);
c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;
d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.

Article 28
Members of
diplomatic missions and consular posts

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Article 29
Territorial extension[5]

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 30 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.

CHAPTER VII
FINAL PROVISIONS

Article 30
Entry into force

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at .... as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
a) (in State A): ....
b) (in State B): ....

Article 31
Termination

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ...... In such event, the Convention shall cease to have effect:

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[5] The words between brackets are of relevance when, by special provision, a part of the territory of a Contracting State is excluded from the application of the Convention.

a) (in State A): ....
b) (in State B): ....

TERMINAL CLAUSE[6]

[6] The terminal clause concerning the signing shall be drafted in accordance with the constitutional procedure of both Contracting States.

Annex 2: UN Model Double Taxation Convention between Developed and Developing Countries

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TITLE OF THE CONVENTION
Convention between (State A) and (State B)
with respect to taxes on income and on capital[1]

PREAMBLE TO THE CONVENTION

CHAPTER I
SCOPE OF THE CONVENTION

Article 1
Persons covered

This Convention shall apply to persons who are residents of one or both of the Contracting States.

Article 2
Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

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[1] States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or both the avoidance of double taxation and the prevention of fiscal evasion.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:
(a) (in State A): ....
(b) (in State B): ....

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law.

CHAPTER II
DEFINITIONS

Article 3
General definitions

1. For the purposes of this Convention, unless the context otherwise requires:
(a) the term "person" includes an individual, a company and any other body of persons;
(b) the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;
(c) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
(d) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
(e) the term "competent authority" means:
  (i) (in State A): ....
  (ii) (in State B): ....
(f) the term "national" means:
  (i) any individual possessing the nationality of a Contracting State;
  (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the pur-

poses of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 4
Resident

1. 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 incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. 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.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
(a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
(b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Article 5
Permanent establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:
(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" also encompasses:

(a) a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

(b) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 7 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

CHAPTER III
TAXATION OF INCOME

Article 6
Income from immovable property

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 7
Business profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to

(a) that permanent establishment;
(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or
(c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2

shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

(NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

Article 8
Shipping, inland waterways transport and air transport

Article 8 (alternative A)

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 (alternative B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than

casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by … per cent. (The percentage is to be established through bilateral negotiations.)

3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9
Associated enterprises

1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

Article 10
Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

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

(a) ... per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;

(b) ... per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

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

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

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

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any

tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11
Interest

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ... per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 12
Royalties

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ... per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent estab-

lishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13
Capital gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:

(1) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.

(2) For the purposes of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of … per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14
Independent personal services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

(a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or

(b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15
Dependent personal services

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16
Directors' fees and remuneration of top-level managerial officials

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.

2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17
Artistes and sportspersons

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

Article 18
Pensions and social security payments

Article 18 (alternative A)

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 18 (alternative B)

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.

2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.

3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 19
Government service

1. (a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:
   (i) is a national of that State; or
   (ii) did not become a resident of that State solely for the purpose of rendering the services.

2. (a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.

3. The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages and other similar remuneration, and to pensions, in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20
Students

Payments which a student or business trainee or apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 21
Other income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

CHAPTER IV
TAXATION OF CAPITAL

Article 22
Capital

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services may be taxed in that other State.

3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

[4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.]

(The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an Article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)

CHAPTER V
METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23A
Exemption method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Article 23B
Credit method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the

other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

CHAPTER VI
SPECIAL PROVISIONS

Article 24
Non-discrimination

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 provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. Stateless persons who are residents of a Contracting State shall not be subjected in either 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 the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such

enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 25
Mutual agreement procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the

implementation of the mutual agreement procedure provided for in this Article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

Article 26
Exchange of information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Article 27
Members of diplomatic missions and consular posts

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

CHAPTER VII
FINAL PROVISIONS

TERMINAL CLAUSE

NOTE: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

Article 28
Entry into force

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at ... as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
(a) (in State A): ....
(b) (in State B): ....

Article 29
Termination

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ... .In such event, the Convention shall cease to have effect:
(a) (in State A): ....
(b) (in State B): ....

Annex 3: OECD Model Convention with Respect to Estate, Inheritance and Gift Taxes

SUMMARY OF THE CONVENTION

Title and Preamble

Chapter I
SCOPE OF THE CONVENTION

Article 1 Estates, inheritances and gifts covered
Article 2 Taxes covered

Chapter II
DEFINITIONS

Article 3 General definitions
Article 4 Fiscal domicile

Chapter III
TAXING RULES

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TITLE OF THE CONVENTION
Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on estates and inheritances and on gifts

PREAMBLE OF THE CONVENTION[1]

CHAPTER I
SCOPE OF THE CONVENTION

Article 1
Estates, inheritances and gifts covered

This Convention shall apply to
- to estates and inheritances where the deceased was domiciled, at the time of his death, in one or both of the Contracting States; and
- to gifts where the donor was domiciled, at the time of the gift, in one or both of the Contracting States.

Article 2
Taxes covered

1. This Convention shall apply to taxes on estates and inheritances and on gifts imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on estates and inheritances taxes imposed by reason of death in the form of taxes on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on donationes mortis causa. There shall be regarded as taxes on gifts taxes imposed on transfers inter vivos only because such transfers are made for no, or less than full, consideration.

3. The existing taxes to which the Convention shall apply are:
(a) (in State A): ....
(b) (in State B): ....

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

[1] The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

CHAPTER II
DEFINITIONS

Article 3
General definitions

1. For the purpose of this Convention, unless the context otherwise requires:
(a) the term "property which forms part of the estate of, or of a gift made by, a person domiciled in a Contracting State" includes any property the devolution or transfer of which, under the law of a Contracting State, is liable to a tax covered by the Convention;
(b) the term "competent authority"
   (i) (in State A): ....
   (ii) (in State B): ....

2. As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article 4
Fiscal domicile

1. For the purposes of this Convention, the term "person domiciled in a Contracting State" means any person whose estate or whose gift, under the law of that State, is liable to tax therein by reason of the domicile, residence or place of management of that person or any other criterion of a similar nature. However, this term does not include any person whose estate or whose gift is liable to tax in that State only in respect of property situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is domiciled in both Contracting States, then his status shall be determined as follows:
(a) he shall be deemed to be domiciled in the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be domiciled in the State with which his personal and economic relations are closer (centre of vital interests);
(b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be domiciled in the State in which he has an habitual abode;
(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be domiciled in the State of which he is a national;
(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is domiciled in both Contracting States, then it shall be deemed to be domiciled in the State in which its place of effective management is situated.

CHAPTER II
TAXING RULES

Article 5
Immovable property

1. Immovable property which forms part of the estate of, or of a gift made by, a person domiciled in a Contracting State and which is situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall also apply to immovable property of an enterprise and to immovable property used for the performance of professional services or other activities of an independent character.

Article 6
Movable property of a permanent establishment or a fixed base

1. Movable property of an enterprise which forms part of the estate of, or of a gift made by, a person domiciled in a Contracting State, which is the business property of a permanent establishment situated in the other Contracting State, may be taxed in that other State.

2. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

3. The term "permanent establishment" includes especially:
(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop; and
(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

4. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

5. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
(e) the maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise any other activity of a preparatory or auxiliary character; or
(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

6. Movable property which forms part of the estate of, or of a gift made by, a person domiciled in a Contracting State, used for the performance of professional services or other activities of an independent character and pertaining to a fixed base situated in the other Contracting State, may be taxed in that other State.

Article 7
Other property

Property, wherever situated, which forms part of the estate of, or of a gift made by, a person domiciled in a Contracting State, and not dealt with in Articles 5 and 6, shall be taxable only in that State.

Article 8
Deduction of debts

1. Debts especially secured on any property referred to in Article 5 shall be deducted from the value of that property. Debts, not being especially secured on any property referred to in Article 5, which are represented by the acquisition, conversion, repair or upkeep of any such property, shall be deducted from the value of that property.

2. Subject to the provisions of paragraph 1, debts pertaining to a permanent establishment referred to in paragraph 1 of Article 6, or to a fixed base referred to in paragraph 6 of Article 6, shall be deducted from the value of the permanent establishment or the fixed base as the case may be.

3. Other debts shall be deducted from the value of property to which the provisions of Article 7 apply.

4. If a debt exceeds the value of the property from which it is deductible in a Contracting State, according to the provisions of paragraphs 1 or 2, the excess shall be deducted from the value of any other property taxable in that State.

5. Any excess still remaining in one Contracting State after the deductions referred to in paragraphs 3 or 4 shall be deducted from the value of the property liable to tax in the other Contracting State.

6. Where the provisions of paragraphs 1 to 5 would oblige one Contracting State to deduct debts to an extent greater than that provided for under its law, those provisions shall apply only to the extent that the other Contracting State is not obliged to deduct the same debts under its own law.

CHAPTER IV
METHODS FOR ELIMINATING DOUBLE TAXATION

Article 9A
Exemption method

1. The Contracting State in which the deceased was domiciled at his death, or the donor was domiciled at the time of the gift, shall exempt from tax any property which, in relation to the same event and in accordance with the provisions of this Convention, may be taxed in the other Contracting State.

2. The former Contracting State shall also exempt from tax any property which, in relation to a previous gift and in accordance with the provisions of the Convention, may have been taxed in the other Contracting State. That former State, however, shall not exempt from tax any property which was taxable in that State in accordance with the provisions of Articles 5 or 6 of the Convention.

3. In each case the former Contracting State may take the exempted property into account in calculating the amount of tax on any remaining property.

Article 9B
Credit method

1. The Contracting State in which the deceased was domiciled at his death, or the donor was domiciled at the time of the gift, shall allow as a deduction from the tax calculated according to its law an amount equal to the tax paid in the other Contracting State on any property which, in relation to the same event and in accordance with the provisions of this Convention, may be taxed in that other State.

2. The former Contracting State shall also allow as a deduction from such tax an amount equal to the tax which has been paid in the other Contracting State on a previous gift in accordance with the provisions of the Convention to the extent

that such a deduction has not been allowed under the provisions of paragraph 1 at the time of that gift. That former State, however, shall not allow a deduction in respect of tax paid on property which was taxable in that State in accordance with the provisions of Articles 5 or 6 of the Convention.

3. The deductions referred to in paragraphs 1 and 2 shall not, however, exceed that part of the tax of the former Contracting State, as computed before any deduction is made, which is attributable to the property in respect of which the deduction is to be allowed.

CHAPTER V
SPECIAL PROVISIONS

Article 10
Non-Discrimination

1. Nationals of a Contracting State, wherever they are domiciled, 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 are or may be subjected.

2 . The term "nationals" means

(a) all individuals possessing the nationality of a Contracting State;

(b) all legal persons, partnerships and associations deriving their status as such from the law in force in a Contracting State.

3. Stateless persons who are domiciled in a Contracting State shall not be subjected in either 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 the State concerned in the same circumstances are or may be subjected.

4. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 11
Mutual agreement procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic laws of those States, present his case to the competent authority of either Contracting State. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2 . The competent authority, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, shall endeavour to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the provisions of the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic laws of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

Article 12
Exchange of information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws or administrative practice of that or of the other State;

(b) to supply information which is not obtainable under the laws, or in the normal course of the administration, of that or of the other State;

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Article 13
Diplomatic agents and consular offices

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.

Article 14
Territorial extension

1. This Convention may be extended, either in its entirety or with any necessary modifications, [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or] to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 16 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.

Note: The words between square brackets are of relevance when, by special provision, a part of the territory of a Contracting State is excluded from the application of the Convention.

CHAPTER VI
FINAL PROVISIONS

TERMINAL CLAUSE[2]

Article 15
Entry into force

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at … as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
(a) (in State A) …
(b) (in State B) …

[2] The terminal clause should be drafted in accordance with the constitutional procedure of both Contracting States.

Article 16
Termination

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year … In such event, the Convention shall cease to have effect:
(in State A) …
(in State B) …

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