VAT in an EU and International Perspective

Essays in honour of Han Kogels

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Art. 24 OECD Model Convention, Residence and VAT

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1. Significance for VAT of Art. 24(6) OECD Model Convention

Art. 2 of the OECD Model Convention on Income and on Capital (OECD Model) regulates the taxes covered by the Convention. Art. 2(1) provides as follows: "This Convention shall apply to taxes on income and 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." An exception applies, however, for purposes of Art. 24. Art. 24(6) provides as follows: "The provisions of the Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description." That extension of the taxes covered, incorporated on a proposal of the Swiss Delegate, could already be found in the Model Convention that had been published in 1963.[2] Art. 24 of the OECD Model hence applies also to value added taxes.

That result requires re-examination: The term "resident" plays an important role in Art. 24, just like the non-discrimination of permanent establishments enshrined in Art. 24(3) that refers to a permanent establishment (PE) "which an enterprise of a Contracting State has in the other Contracting State". Art. 3(1)(c) defines "enterprise of a Contracting State" as an "enterprise carried on by a resident of a Contracting State". The term "resident of a Contracting State", in turn, is described in Art. 4(1) as follows:

> For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or

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2. See OEEC, Working Party No. 4 of the Fiscal Committee, Supplementary Report on Tax Discrimination on Grounds of Nationality or Similar Grounds, 10.5.1957, FC/WP4(57)2, at 1 et seq.; see also OEEC, Fiscal Committee – Minutes of the 4th Session held at the Château de la Muette, Paris, on 4-7 June 1957, 3.7.1957, FC/M(57)2, at 3 et seq.; the historic OEEC and OECD documents are available at http://www.taxtreatieshistory.org/.

> 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.

The definition of Art. 4(1) seems to postulate worldwide taxation. What consequences does this have for Art. 24(3)? Art. 4(1) was certainly not developed primarily against the backdrop of Art. 24(3), but rather with a view to the provisions on the persons covered by the Convention, because Art. 1 of the OECD Model directly builds on the definition of Art. 4(1). Although the residence requirements laid down in the distributive rules and the provisions on the methods for elimination of double taxation, incorporating by reference "residents" as defined in Art. 4(2) and (3), are much narrower, the definition of "resident" incorporated therein is, however, based on the general rule of Art. 4(1) and determines which state is the residence state for tax treaty purposes if an individual is a resident of both contracting states. Arts. 1 and 4(1) therefore primarily have in mind those taxes that are covered by the distributive rules and the provisions on the methods for elimination of double taxation. Many states characteristically distinguish between the universal and the territorial principle with respect to these taxes on income and on capital.

Still, understanding the reference to residents in Art. 24(3) of the OECD Model to mean that this non-discrimination clause applies only to those taxes that are also conceived according to the universal principle would not do justice to the provision of Art. 24(6), which speaks of "taxes of every kind and description" and hence contains a specific exemption from Art. 2. Had it been the intention of the authors of the OECD Model Convention to apply the non-discrimination of PEs enshrined in Art. 24(3) only to the taxes on income and on capital covered by Art. 2 and to a few other taxes which provide for worldwide taxation as well, they would neither have created such a general exception to Art. 2 nor introduced general language such as "taxes of every kind and description". Although having introduced a general exception to the restrictions of Art. 2, the authors of the Convention cannot be assumed to have broadly excluded all value added taxes hidden in the concept of "resident" in Art. 24(3).[3]

3. See Dziurdź K., "Umsatzsteuerbefreiung für Kleinunternehmer und Diskriminierungsverbote in Doppelbesteuerungsabkommen", *Steuer und Wirtschaft International* (2010) at 266 (at 267 et seq.); Bourgeois & Römer, "Effects of Existing Tax Treaties on VAT (Relevance of Arts. 24-27 OECD Model for VAT/GST)", in Lang/Melz/Kristoffersson (eds.), *Value Added Tax and Direct Taxation – Similarities and Differences*, 2009, at 1231 (at 1233 et seq.).

2. Significance for VAT of Art. 4(1) OECD Model

A more thorough look at Art. 4(1) will confirm that result. The first very general sentence, already incorporated in the 1963 OECD Model Convention, is the heart of this provision. The qualifying second sentence was added as late as 1977 and was initially not considered all that important. That sentence was supposed to clarify that certain individuals, such as foreign diplomatic and consular staff, should not be entitled to the benefits of the tax conventions of their host states, although they were domiciled there and were regularly subject to taxation of income and capital in that state.[4] Apparently much later did the members of the OECD Committee on Fiscal Affairs become aware of the far-reaching meaning of the second sentence of Para. 1. As a result, comprehensive Commentaries were added: The Committee first tried to qualify that sentence, noting that persons who are subject to taxation in those states which adopt a territorial principle in their taxation should not be excluded from the scope of application of the Convention.[5] On the other hand, the OECD Committee on Fiscal Affairs now argued in reliance on the wording of the second sentence of Para. 1 why conduit companies or companies resident in both contracting states could be denied the tax benefits if particular privileges exist to attract those companies.[6]

A detailed analysis of the wording of the *second sentence* of Para. 1 shows, however, that the qualification of that sentence can certainly not be of any significance for value added taxes. That provision excludes any person who is liable to tax in that state in respect of only *income* from sources in that state or *capital* situated therein. Other than the first sentence of Para. 1, which is entirely general in nature, that provision specifically takes up *taxes on income and on capital*. That provision can hence not be significant for taxes other than those referred to in Art. 2 of the OECD Model. To the extent that Art. 24(3) requires that a state of residence must have been determined for purposes of VAT as well, *only the first sentence* of Art. 4(1) can be of interest.

Proceeding on the assumption that the definition of “resident” in the first sentence of Art. 4(1) of the OECD Model should be relevant also for any tax guided by the territorial principle, that definition, namely “any person who, under the laws of that State, is liable to tax therein by reason of his

4. OECD Commentary 2010, Art. 4, Para. 8.1.
5. OECD Commentary 2010, Art. 4, Para. 8.3.
6. OECD Commentary 2010, Art. 4, Para. 8.2.

domicile, residence, place of management and any other criterion of similar nature" could also be relevant for VAT taxpayers. In any event, it is certainly not permissible to interpret the first sentence of Art. 4(1) to mean that the criteria mentioned therein should subject these taxpayers to taxation also outside the territory of the contracting state. Eventually, this would mean that residence cannot carry any weight in case of taxation based on territory and that Art. 24(3) would hence not be applicable to VAT. The reference to those criteria can rather mean only that those taxpayers can be considered residents who either have their "domicile, residence" or "place of management" in that contracting state. By extending the residence criteria to "any other criterion of similar nature" the first sentence of Art. 4(1) obviously means those criteria which can establish a similar strong connection to the contracting state as that which can be established by the place of management, the place of establishment or the state of nationality. Eventually, the meaning of non-discrimination on the VAT level amounts to the precept that VAT taxpayers who have only one PE in a contracting state may not be discriminated compared to VAT taxpayers with their domicile, place of management, residence, place of abode or another similarly strong connection to the contracting state.[7]

Dziurdź quite rightly moots whether the exemption for small undertakings resident in a Member State, which the European Court of Justice (ECJ) discussed in *Schmelz*,[8] might be objectionable for the purpose of tax treaty law.[9] Although the qualification of the exemption for small enterprises to residents is consistent with primary and secondary Union law, this does not mean that this differentiation is also justified against the backdrop of Art. 24(3) of the OECD Model. Due to the primacy of Union law over bilateral international treaties, that question may be alleviated within the EU. However, in relation to third states, it is not finally resolved whether national VAT legislation of the Member States adopted to implement EU Directives complies with the requirements of Art. 24(3).

3. Significance for income taxes of Art. 4(1) OECD Model

The insight gained in the field of VAT can enrich the discussions in the field of income taxes. A look at VAT law reveals that partnerships can also be "residents". For VAT purposes, partnerships may be taxable; the above

7. Dziurdź, *Steuer und Wirtschaft International* (2010), op. cit., at 269 et seq.
8. ECJ, 26 October 2010, Case C-97/09, *Schmelz*.
9. Dziurdź, *Steuer und Wirtschaft International* (2010), op. cit., at 266 et seq.

reflections have shown that the fact that no specific form of tax liability is connected with residence, domicile, place of management or any other similar criterion in the field of value added tax, cannot be harmful for residency. The criteria referred to in the first sentence of Art. 4(1) OECD Model rather reveal the connection that must exist to qualify a person as resident.

The definition of "resident" in the first sentence of Art. 4(1) does not distinguish between certain forms of tax. If a partnership can be "resident" pursuant to Art. 24(1) of the OECD Model for VAT purposes, that partnership can invariably also be considered as a "resident" for purposes of income tax. In most cases, this will have no impact in practice. If a partnership is considered transparent according to income tax rules and if national laws allocate its income to the shareholders "behind it", residency of a partnership for treaty purposes will have no practical impact. If only the shareholders – rather than the partnership itself – are liable to pay income tax under national laws, only these shareholders can rely on the tax treaty benefits. In these scenarios, the partnership cannot invoke treaty benefits.

The situation is different if the partnership itself is taxable under national income tax laws. The partnership will be taxed and hence liable also under national tax law. Consistently enough, its qualification as resident will allow it to invoke treaty benefits and exercise those rights granted in tax treaties.[10] No further doubt about that when a partnership is treated as taxable person by both contracting states.

It is, however, controversial for a state from which a partnership receives dividends, interest, royalties or other income to consider that partnership taxable for purposes of income tax, while the partnership's state of residence considers it transparent and allocates income to its shareholders. In this context, the OECD Partnership Report took the view that such a partnership is not entitled to the benefits of a tax convention in the state of source.[11] Accordingly, the relevant criterion shall only be the income recipient's treatment for income tax purposes in his state of residence.

10. See, e.g. Lang, M., *The Application of the OECD Model Tax Convention to Partnerships – A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (2000); Prokisch, R. in Vogel & Lehner, *Doppelbesteuerungsabkommen* (2008), Art. 1, Para. 26.

11. OECD, The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation No. 6 (1999), Example 7, Para. 69 et seq.

Among others, I take the opposite view and believe that qualification in the source state is relevant.[12] According to the income tax rules of the source state, tax is collected at source in the form of income tax imposed on the partnership. Only the partnership can therefore make an application for a tax refund. A direct relief at source of tax collected from the partnership as the recipient of income can similarly be based only on the partnership's relevant entitlement. Acknowledging that a partnership can qualify as "resident" even if it is not liable to pay income tax in the state of residence and allowing its qualification as "resident" based on the fact that it has its residence, place of management or any other similarly close connection in that state, nothing speaks for denying a partnership that is treated as transparent in the state of residence its qualification as 'resident' and hence the entitlement to benefits of a tax convention in the source state. The reflections in connection with VAT have shown that even a partnership that is transparent for purposes of income tax may be resident in its state of residence. Whoever gives priority to the first sentence of Art. 4(1) of the OECD Model and requires for qualification of a person as a "resident" in a contracting state for that person to be taxable according to the laws of that state should not have any problems against this backdrop: The first sentence of Art. 4(1) does not distinguish individual forms of tax; the concept of residence is hence undivided and residence by virtue of VAT liability is sufficient.

The wording of the *second sentence* of Art. 4(1) cannot cast doubt on that result. Whenever a partnership is income tax-transparent in its state of residence, the second sentence of Art. 4(1) cannot be relevant. Because that person is not liable to tax in that state with respect to *income* from sources in that state or *capital* situated therein. The qualification in that sentence does not even pursue the purpose of depriving tax-transparent partnerships of their status as residents. In fact, that provision was originally conceived to cover persons with much closer connections to a third state, such as diplomats in relation to their home state.[13] A partnership, on the other hand, has a much closer connection to its state of residence than to the state from

12. See, e.g., Lang, *Application*, op. cit., at 38 et seq.; Lang, M., "Personengesellschaften im DBA-Recht", *Steuer und Wirtschaft International* (2000) at 60 et seq.; Lang, M., Reich, M. & Schmidt, C., "Personengesellschaften im Verhältnis Deutschland-Österreich-Schweiz", *Internationales Steuerecht* (2007) at 1 (at 5); Lang, M., "Qualifikationskonflikte bei Personengesellschaften", *Internationales Steuerecht* (2000) at 129 et seq.; Lang, M., "Steuerlich transparente Rechtsträger und Abkommensberechtigung", *Internationales Steuerecht* (2011) at 1 (at 2); similarly, Vogel, K., *On Double Taxation Conventions*, 3d edn, 1997, Art. 1, Para. 25a; open Prokisch in Vogel, K. & Lehner, M., *Doppelbesteuerungsabkommen*, 5th edn, Art. 1, Para. 36.

13. See, already, OECD Commentary 1977, Art. 4, Para. 8; see also Lehner, M. in Vogel, K. & Lehner, M., *Doppelbesteuerungsabkommen,* 5th edn, Art. 4, Para. 120.

which it merely receives income. It is irrelevant for that purpose whether the state of residence treats the partnership as a taxable entity for purposes of income tax.