

Income Allocation Issues Under Tax Treaties

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SPECIAL REPORTS

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I. The Proceedings

The case of *Her Majesty the Queen v. Peter Sommerer* was first decided by the Tax Court of Canada¹ and then by the Federal Court of Appeal,² and dealt with issues of income allocation regarding an Austrian private foundation whose beneficiary resided in Canada.

These proceedings dealt primarily with questions of Canadian tax law: In the case of a foreign trust, subsection 75(2) of the Income Tax Act provides under

¹Tax Court of Canada, May 13, 2011, 2007-2583(IT)G, *Her Majesty the Queen v. Peter Sommerer*, 2011 TCC 212.

²Federal Court of Appeal, July 13, 2012, A-188-11, *Her Majesty the Queen v. Peter Sommerer*, 2012 FCA 207.

some circumstances that the income of the foreign entity can be allocated to a beneficiary in Canada. The courts had to rule whether this Canadian provision is also applicable to Austrian private foundations and whether Sommerer, resident in Canada, had a scope of influence on the private foundation that the profits achieved by it through the alienation of shares should be taxed in Canada as his own income. Following a thorough analysis of the Austrian private foundation law and the foundation declaration, the court of first instance and the court of appeal concluded that such a tax liability does not exist. Therefore, the discussion of whether the Austria-Canada income tax treaty prevents the Canadian taxation was, in the end, not relevant for the decision. Nonetheless, the rulings of both courts contain interesting deliberations on this issue, which are analyzed below.

II. The Reasoning of the Courts

A. Formulation of Canadian Law

At the center of the legal discussion was Article XIII(5) of the Austria-Canada treaty, which corresponds to article 13(5) of the OECD model treaty and allocates the exclusive right of taxation for the relevant gains from the alienation of property — Canadian stocks — to the state of residence. A contentious issue between the parties was whether this provision allows for taxation according to subsection 75(2) of the ITA (if it were proven to be applicable). Judge Campbell J. Miller of the Tax Court of Canada wrote:

The Appellant argues that subsection 75(2) of the *Act* is inconsistent with Article XIII(5) and therefore Article XIII(5) prevails, precluding the taxability in Canada of the gains from the SPF [Sommerer Private Foundation = Sommerer Privatstiftung]'s sale of the Vienna and Cambrian shares. The Respondent's position is that Article XIII(5) applies only to prevent juridical double

taxation, that is the same taxpayer being taxed on the same gain in two different jurisdictions, but not applicable to economic double taxation where the same transaction is taxed in two different persons' hands in two jurisdictions. This could lead to a discussion worthy of an extensive paper, but it is not a path I feel I need to go down. What is before me is the interpretation of a Treaty provision, which is unambiguous: gains from the alienation of property, in this case the Vienna and Cambrian shares, shall be taxable only in the state of which the alienator, the SPF, is a resident — Austria. *Prima facie* this removes the very same gains on the sale of shares from the Canadian taxing authorities. . . . Does subsection 75(2) of the *Act*, however, deem Mr. Peter Sommerer to be the alienator? No, it recognizes the trust is the alienator but that the gain could be Mr. Sommerer's. A fine distinction perhaps, but a distinction nonetheless, the effect of which there is only one alienator — the SPF.³

The Tax Court of Canada thus assumed that for the purposes of treaty law, the gains from the alienation of property were to be allocated exclusively to the Austrian private foundation. The judge allocated this to the formulation chosen by the Canadian legislature in subsection 75(2) of the ITA: The income of the foreign trust (provided that this rule applies) is deemed to be income of the person resident in Canada. The provision refers to the profits generated by the trust and allocates them to the person resident in Canada. The court concluded that the Canadian legislature recognizes for the purposes of treaty law that this constitutes income of the trust, which will simply be taxed in another person's hands in Canada.

Such reasoning is not conclusive: Admittedly, the national law of each of the two contracting states is relevant for determining income allocation. That is, treaty law does not contain any separate allocation provisions but refers to national law. According to subsection 75(2) (to the extent that it would prove applicable) the income must be allocated to the person resident in Canada. The *formulation* chosen by the Canadian legislature simply cannot be relevant. Whether the legislature first refers to the income of a foreign trust that is then taxed in the hands of the person resident in Canada or, right from the start, only to the income of the person resident in Canada, is merely a technique of legal drafting. In both cases, the legal consequences under national law are the same. Therefore, the formulation cannot be relevant for the purposes of treaty law, either. What matters is the *result* of the application of the Canadian provisions. The allocation of income is made to whoever is taxed on it. Consequently, for the purposes of treaty law, it must be assumed that if sub-

section 75(2) is applied, income will be allocated under Canadian tax law to the person resident in Canada.

B. Comparison of Income Tax Treaties

For the Tax Court of Canada, it was also instrumental that the Austria-Canada treaty contains a caveat in favor of the provision under subsection 91 of the ITA (here undisputedly irrelevant), while no similar caveat was provided regarding subsection 75(2). Most of Canada's other treaties, however, include a saving clause, which expressly provides for the application of Canadian tax law even in the case of penetration through a foreign trust. The lack of such a provision in the Austria-Canada treaty led the court to the *argumentum e contrario*, according to which taxation in Canada in relation to Austria is already ruled out under treaty law. The court said:

[115] Had the drafters of the *Convention* intended to make an exception that the general and clear provision of Article XIII(5) was not to apply to the attribution rules contained in subsection 75(2) of the *Act*, they could have done so. In this regard, it is interesting to note Article XXVIII(2) of the *Convention* which provides:

Nothing in this Convention shall be construed as preventing Canada from imposing its tax on amounts included in the income of a resident of Canada according to section 91 of the *Canadian Income Tax Act*. However, that section shall not apply to income from an active business carried on in Austria by a foreign affiliate of a person resident in Canada or to income that pertains to or is instant to an act of business carried in Austria.

[116] It is clear that the drafters wanted to ensure the terms of the *Convention* would not override Canada's *FAPI* legislation, which could tax income in Canada, that had also been subjected to tax in Austria in a different entity's hands. No such provision is to be found in the *Convention* referencing subsection 75(2) of the *Act*, notwithstanding that 56 of the 88 *Income Tax Conventions* in force in Canada have provisions such as found in the *Canada-Germany Income Tax Convention*, Article 29(2)(a):

It is understood that nothing in the Agreement shall be construed as preventing:

(a) Canada from imposing a tax on amounts included in the income of a resident of Canada with respect to a partnership, trust or controlled foreign affiliate, in which that resident has an interest;

[117] The absence of a similar saving provision in the *Convention* supports the position that Canada has not preserved the jurisdiction to tax residents

³Tax Court of Canada, May 13, 2011, 2007-2583 (IT)G, *Her Majesty the Queen v. Peter Sommerer*, 2011 TCC 212, p. 45.

such as Mr. Sommerer, with respect to his interest in an Austrian trust.⁴

Even in the interpretation of national provisions, such reasoning must be treated with caution: When the legislature makes express provisions for specific situations, one should not necessarily conclude that the scope of these provisions is limited to only those situations explicitly covered by such provisions. It could be just as advisable to apply this provision by analogy to the situations not expressly mentioned. Whether an *argumentum e contrario* or a conclusion by analogy is necessary will be a matter of interpretation in each individual case, and will therefore require a careful analysis of all aspects relevant in the interpretation. It is not possible to make a general assumption in favor of an *argumentum e contrario* or a conclusion by analogy.⁵ Although postulations on the rule of law may often demand that legislatures issue express rules, equal treatment considerations may suggest that similar situations are to be covered by the scope of a legislative provision regardless of its wording. For merely declarative regulations, one should not assume that the legislature intended to provide for a *different* legal consequence outside the expressly defined scope, and thus possibly to implicitly transform the legal situation through the clarification.

In the case of treaty provisions deviating from the OECD model, there is even less reason to generally draw the *argumentum e contrario*⁶ — treaties are the result of bilateral negotiations. As long as the two parties base their provisions on one of the models, one should expect that they will incorporate those provisions into the treaty with the content that befits them according to the model treaty.⁷ During these negotiations, however, uncertainties occasionally arise regarding the content of a provision of the model treaty or its impact on national law. As a result, the parties may agree to explicitly enshrine their desired provisions in the treaty. This does not imply that something else would apply if this provision deviating from the model had not been included in the treaty. It is possible that the interpretation of the provisions of the model would have led to the same result. The two sides, however, introduced the

clarification to prevent any potential interpretation conflicts from emerging in the first place.

Therefore, a special provision is no indication that something else applies outside its explicitly defined scope of application. Such a deviation from the OECD model can often be better understood against the background of the negotiations, during which doubts arose about the application of a provision to a specific situation that the negotiators had in mind. The negotiators would then want to eliminate these doubts. Therefore, such provisions often serve to solve a specific issue. This does not provide any clue about what applies when the regulation did not seem questionable during the negotiations or did not come under consideration. The uncertainties that arise during negotiations may vary from treaty to treaty. If the provisions chosen by the two sides are characterized by an effort to solve the uncertainties that arise in the respective negotiations, the provisions formulated against this background, which will eventually be included in the treaty, may significantly differ. Different wordings in the provisions of various treaties, however, do not suggest that different contents are concealed. Therefore, reverse conclusions that are substantiated only by deviations in the wording and without any further persuasive arguments must be met with even greater skepticism.

This also applies when a specific special provision can be found in most treaties of a state and is missing only in a few treaties. The reasons for the lack of such a special provision vary. The state that usually insists on such a special provision during negotiations may not deem it necessary against the background of the other state's legal system. This is because special provisions have a "price" in negotiations, and it may prove useful to enforce a provision on a different, substantially more important field than the mere clarification of one issue. Depending on the negotiating position, the contracting parties may be willing to give in to wishes of the other side.

The Austria-Canada treaty does not contain an express provision explicitly entitling Canada to look through a foreign trust and to allocate the income to the other state for purposes of the Canadian income tax to a person resident in Canada who has an influence on this trust, and does not justify any conclusions whether the taxation of income in the hands of the person resident in Canada is admissible under the treaty. If the provisions of the treaty are limited to only expressly addressing the admissibility of looking through subsidiaries, the reason for this may be, for instance, that private foundations did not yet exist at the time of the negotiations on the original version of the treaty. In Austria, the legal basis for the establishment of private foundations was created in 1993.⁸ The

⁴Tax Court of Canada, May 13, 2011, 2007-2583 (IT)G, *Her Majesty the Queen v. Peter Sommerer*, 2011 TCC 212, p. 46.

⁵See Bydlinski, *Grundzüge der juristischen Methodenlehre* (2011), 86 et seq.; Larenz, *Methodenlehre der Rechtswissenschaften* (1995), 209 et seq.; Potacs, *Auslegung im öffentlichen Recht* (1994), 200 et seq.

⁶Vogel, "Abkommensvergleich als Methode der Auslegung von Doppelbesteuerungsabkommen," *StbJb* 1983/84, 373 (373 et seq.); Reimer, "Der Rechtsvergleich im Internationalen Steuerrecht: Fragestellungen und Methoden," in: Lehner (eds.), *Reden zum Andenken an Klaus Vogel* (2010), 89 (122 et seq.).

⁷Lang, "Die Bedeutung des Musterabkommens und des Kommentars des OECD-Steuer Ausschusses für die Auslegung von Doppelbesteuerungsabkommen," in: Gassner, Lang, and Lechner (eds.), *Aktuelle Entwicklungen im Internationalen Steuerrecht* (1994), 11 (22 et seq.).

⁸On the development of such law, see H. Torggler, "Reformanliegen zum Privatstiftungsgesetz," *ÖStZ* 2004, 394 (394 et seq.).

fact that the Austria-Canada treaty explicitly mentions the allocation of the income of a subsidiary to a partner and that other Canadian treaties also address income allocation for trusts does not lead to the conclusion that the treaty provisions rule out such a look-through approach in those situations that are not expressly addressed.

C. The Meaning of the OECD Commentaries

Another thread of the argument in the ruling of the Tax Court of Canada deals with the meaning of the OECD commentary:

[118] The Respondent argues that it is unnecessary to have these types of saving provisions in *Conventions*, citing both a recent (2009) Japanese Superior Court . . . decision in the *FAPI* context, as well as recent (2003) OECD Commentary on Article 1 of the OECD Model Tax Treaty. The Appellant takes exception with the Respondent's reliance on the 2003 OECD Commentary, which states in paragraphs 22 and 22.1 that domestic anti-avoidance rules like "substance over form", "economic substance" and "General Anti-Avoidance Rules (GAAR)" are "part of the basic domestic rules set by domestic tax laws 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." The Appellant contends this Commentary is contrary to the 1977 OECD Commentary coincident with the entering of the *Convention*, and it is only the earlier OECD Commentary that is relevant. In 1977, the OECD Commentary suggests that if a State intended that a domestic anti-avoidance provision remain applicable in the treaty context, it would have to incorporate it into the treaty, similar to the *FAPI* rules. The Respondent's view is that since the 1977 Commentary did not go into great detail, the 2003 Commentary was simply an elaboration and, consequently, the two OECD Commentaries are not in conflict, and it is therefore appropriate to rely on the latter. I disagree. The Federal Court of Appeal in *Her Majesty the Queen v. Prévost Car Inc.* . . . stated:

10. The worldwide recognition of the provisions of Model Convention and their incorporation into a majority of bilateral Conventions have made the Commentaries on the provisions of the OECD Model a widely-accepted guide to the interpretation and application of the provisions of existing bilateral Conventions. . . .

11. The same may be said with respect to later commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries. . . .

[119] A later OECD Commentary should only be of assistance if not in conflict with the Commentary in existence at the time of the *Convention*. I find the two Commentaries are very much in conflict, and I restrict myself to looking to the 1977 Commentaries for help. It supports the Appellant's view that specific mention should have been made in the *Convention* to permit the application of domestic anti-avoidance rules such as subsection 75(2) of the *Act* to override the effect of Article XIII(5) of the *Convention*. Failing that, Article XIII(5) can only be interpreted in its ordinary sense, which would preclude the application of subsection 75(2) of the *Act* to tax the gain in Mr. Sommerer's hands in Canada.

[120] This is certainly a view which found favour with Justice Woods in *Garron et al v. The Queen* . . . where she concluded that a similar provision of the *Canada-Barbados Income Tax Convention* took precedence over the application of subsection 75(2) of the *Act*.

[121] The Respondent relied on *obiter* comments I made in the case of *Antle v. The Queen* . . . where I discussed the application of GAAR to the interplay between the *Act* and the *Canada-Barbados Income Tax Convention*. That was an entirely different situation decided on different grounds. It appears no significance was attached to the differing OECD Commentaries, and that I may have been applying the more recent OECD Commentary in suggesting GAAR applies to find a Canadian resident taxable on gains of a Barbados trust, but it is implicit in the reasoning in *Antle* that I looked on Mr. Antle as the alienator of property — not a finding I have made with respect to Mr. Sommerer. Also, in this case I am not dealing with the GAAR but a specifically worded anti-avoidance provision, precluding the application of section 4.1 of the *Income Tax Convention Interpretation Act*.

[122] Based on the clear wording of Article XIII(5), section 5(2) of the *Canada-Austria Income Tax Convention Act* 1980, the 1977 OECD Commentary, the lack of a provision in the *Convention* similar to Article 29(2)(a) of the *Canada-Germany Income Tax Convention*, and the decision in *Garron*, I conclude Article XIII(5) applies to preclude Canada from taxing Mr. Sommerer on the gain on the disposition of the Vienna and Cambrian shares by the SPF.⁹

First, one must agree with the court that the version of the OECD commentary available at the time the treaty was concluded must be used for the interpretation of a treaty based on a specific version of the

⁹Tax Court of Canada, May 13, 2011, 2007-2583 (IT)G, *Her Majesty the Queen v. Peter Sommerer*, 2011 TCC 212, pp. 46-48.

OECD model. The assumption that the provisions incorporated unchanged from the OECD model must be understood in the meaning attributed to them by the authors of the commentary *at the time* is justified.¹⁰ Just as the material generated during a legislative process provides clues about the intention of the lawmakers, the OECD commentary in existence at the time of the negotiations expresses the understanding of the negotiators regarding the contents of a provision they incorporated from the OECD model.¹¹ The rules on the interpretation of international treaties confirm this result: The OECD commentary can be considered not only under article 32 of the Vienna Convention on the Law of Treaties (VCLT), but also based on article 31(1), (2), and (4) of the VCLT.¹²

In this particular case, the court refused to use the version of the OECD commentary created after the treaty was signed to interpret the treaty. This is conclusive because there is no reason to assume that the treaty negotiators had already anticipated a future commentary opinion when they incorporated specific provisions from the OECD model.¹³ Articles 31 and 32 of the VCLT do not provide a basis for attaching any importance to later commentaries. A debate over whether article 31(3) of the VCLT can play a role here is superfluous simply because the OECD commentary does not constitute an “agreement” between the contracting parties and because it is anything but self-evident that an opinion expressed in the OECD commentary reflects a “subsequent practice.”¹⁴

The differentiated reasoning adopted by the court, however, is not very conclusive: “A later OECD Commentary should only be of assistance if not in conflict with the Commentary in existence at the time of the *Convention*.”¹⁵ If the later version of the OECD commentary generally does not constitute a relevant interpretation material, it also cannot be relevant whether the later version is in conflict with the earlier version. The opinion of the Canadian court is reminiscent of those voices that are trying to defuse the controversy over the relevance of later OECD commentaries with a conciliatory solution¹⁶: Some authors contemplate using the later OECD commentary at least when the

opinion now held in the OECD commentary is merely a “clarification,” that is, it would not effect any change.¹⁷

One cannot deny the allure of conciliatory solutions, but it is of little help in this particular case. The mere mention of the word “clarification” calls for skepticism. It is often the case in some states that the tax officials guiding the hand of legislators describe a provision as a clarification in order to then have an easier job enforcing that the clarifying provision is also relevant for the past. It cannot be determinative whether the authors of the OECD commentary therefore describe a change as a clarification.

To determine whether a change or addition really is a mere clarification requires a comparison of the contents of the provision *before* the change or addition with the opinion *now* expressed. If the contents of the earlier version are different, it does not constitute a clarification. If, however, the content is identical, the new version of the commentary is equally unnecessary, since the materials available at the time of the negotiations and of the signing of the treaty already allow for a conclusive judgment. Otherwise, it would not have been possible at all to accept a clarification. Therefore, in cases of a “clarification,” the already existing version of the provision is the actual basis for interpretation.¹⁸ Hence, the court should have been consistent and regarded later versions of the OECD commentary as insignificant for the interpretation of previously entered treaties.

In this particular case, however, the discussion conducted by the court about the differences between the commentary versions is missing the point: It cannot be relevant whether subsection 75(2) serves antiavoidance purposes. The provision is an allocation rule that can lead to the income being taxed in the hands of a person resident in Canada. If this were to result in the taxation in Canada of Sommerer (who is resident there), it would cause a conflict of allocation, since Austrian tax law allocates the income to the private foundation. Therefore, the legal questions actually relevant here are which legal consequences will be triggered under treaty law in such an allocation conflict.

D. Economic Double Taxation

This conflict of allocation was clearly identified by the Federal Court of Appeal. One must agree with the court that the consequence is economic double taxation — the same increases in value are subject to taxation in the hands of different persons in different states:

¹⁷See Loukota, “The importance of the new OECD transfer price guidelines for the Austrian taxation practice,” *SWI* 1997, 339 (342); Jirousek, “Kritische Anmerkungen zur Auslegung von Doppelbesteuerungsabkommen,” *SWI* 1998, 112 (116).

¹⁸See Lang, *supra* note 16, at 606 et seq.

¹⁰For more detailed analysis, see Lang, *supra* note 7, at 22 and 30 et seq.

¹¹Lang, “Wer hat das Sagen im Steuerrecht,” *ÖStZ* 2006, 203 (207).

¹²See Lang, *supra* note 7, at 16 et seq.

¹³See Lang, *supra* note 7, at 30 et seq.

¹⁴See Lang, *supra* note 7, at 25 et seq.

¹⁵Tax Court of Canada, May 13, 2011, 2007-2583 (IT)G, *Her Majesty the Queen v. Peter Sommerer*, 2011 TCC 212, p. 47.

¹⁶See Lang, “DBA und Personengesellschaften — Grundfragen der Abkommensauslegung,” *IStR* 2007, 606 (606 et seq.).

[66] The OECD model conventions, including the *Canada-Austria Income Tax Convention*, generally have two purposes — the avoidance of double taxation and the prevention of fiscal evasion. Article XIII(5) of the *Canada-Austria Income Tax Convention* speaks only to the avoidance of double taxation. “Double taxation” may mean either juridical double taxation (for example, imposing on a person Canadian and foreign tax on the same income) or economic double taxation (for example, imposing Canadian tax on a Canadian taxpayer for the attributed income of a foreign taxpayer, where the economic burden of foreign tax on that income is also borne indirectly by the Canadian taxpayer). By definition, an attribution rule may be expected to result only in economic double taxation.

[67] The Crown’s argument requires the interpretation of a specific income tax convention to be approached on the basis of a premise that excludes, from the outset, the notion that the convention is not intended to avoid economic double taxation. That approach was rejected by Justice Miller, correctly in my view. There is considerable merit in the opinion of Klaus Vogel, who says that the meaning of “double taxation” in a particular income tax convention is a matter that must be determined on the basis of an interpretation of that convention (*Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD -, UN -, and US Model Conventions for the Avoidance of Double Taxation on Income and Capital*, 3rd ed. (The Hague: Kluwer Law International, 1997)).¹⁹

On closer consideration, however, the court’s line of reasoning proves inconclusive. Admittedly, it is true that one would go too far in assuming that treaties do not even address cases of economic double taxation. After all, article 9 of the OECD model is an important treaty provision that undisputedly deals with such situations. On the other hand, however, this does not mean that treaties generally prevent economic double taxation.²⁰ When the court argues that the meaning of the term “double taxation” is a matter that must be determined on the basis of interpretation, this is not fully correct. “Double taxation” is not a legal term that requires interpretation. The direction, however, is right: It must be determined whether it covers cases of economic double taxation. It is not understandable why the court still assumes that the application of the treaty *generally* leads to the avoidance of economic double taxation.

The court not only assumes that the treaty obliges the parties to avoid economic double taxation, it also

assumes that Canada is the state subject to this obligation and that it must refrain from taxation. As a result, the court refuses to accept that the allocation of income for tax purposes is not a factual issue, and that is it not required by the tax law systems either. Each tax law system is free to decide on the allocation issue. No allocation decision is “better” or “more correct” beforehand. Just as the Austrian legislature is free to allocate income to the entity that has the possibility of exploiting the market opportunities presented to it, to provide or to reject services,²¹ and thus to allocate the increases in value to the private foundation, the Canadian legislature is at liberty to allocate them under subsection 75(2) of the ITA to the beneficiary of an Austrian foundation who is resident in Canada.

III. The Solution

A. Allocation in Other State

In the case of allocation conflicts, it seems obvious to take a look at the OECD partnership report.²² The report deals with allocation conflicts that arise because a tax law system allocates, for example, dividends, interest, or royalties to a partnership, while under the other state’s tax law system these are taxed in the hands of the partners. The report may not be legally relevant and the inclusion of some of the ideas contained therein in the OECD commentary in 2000 is not relevant for the interpretation of the Austria-Canada treaty. In the partnership report, however, the OECD has attempted to develop solutions for an important group of allocation conflicts. Against this backdrop, I will validate the report’s proposals using the allocation conflicts under consideration.

The underlying principles of the partnership report are explained by using case studies. Case study 16 is based on a situation that resembles one that the Canadian courts had to decide:

Example 16: P is a partnership established in State P. Partner B is a resident of State R while partner A is a resident of State P. State P treats the partnership as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State R that is not attributable to a permanent establishment in State R. P has an office in State P and may therefore be considered to have a permanent establishment in State P.²³

The considerations made by the Canadian courts regarding treaty law are based on the assumption that Austria treats the private foundation as a taxpayer,

¹⁹Federal Court of Appeal, July 13, 2012, A-188-11, *Her Majesty the Queen v. Peter Sommerer*, 2012 FCA 207, p. 26.

²⁰As in Kubik, “Eine österreichische Privatstiftung ist kein Common Law Trust,” *ZFS* 2012, 162 (167).

²¹See, e.g., *VwGH* 19 Nov. 1998, 97/15/0001; see also Kubik, *id.* at 167.

²²OECD, “The Application of the OECD Model Tax Convention to Partnerships,” *Issues in International Taxation* No. 6 (1999).

²³*Id.* at p. 45.

while Canadian tax law treats it as transparent. If from this point of view one compares the private foundation with a partnership, Austria is in the position of State P and Canada in that of State R. While case study 16 concerns royalties originating in State R, the Canadian courts had to decide on the gains from the alienation of Canadian shares. In both cases, the income is from a state in which the tax law system allocates it to a recipient resident in that state.

The partnership report initially presents the following solution:

126. Some delegates took the position that the R-P Convention prevents State R from taxing in that situation. On the basis of paragraph 1 of Article 12, which provides that royalties arising in State R and paid to a resident of State P are taxable only in State P if the resident is the beneficial owner thereof, they argued that because the partnership qualifies as a resident of State P and is the beneficial owner of the royalties, the conditions of the paragraph are met and the royalties may only be taxed in State P. The delegates who adopted that interpretation therefore concluded that unless the case fell under the application of CFC rules or the Convention included a special provision allowing State R to tax its residents in such circumstances (e.g. a specific provision applicable to partnerships or a so-called “saving clause” such as is found in Conventions concluded by the United States), the Convention would prevent State R from taxing partner B on his share of the royalties.²⁴

This reasoning is characterized by an effort to also solve this case in line with the other principles developed in the OECD partnership report; the OECD report makes a distinction between the source state and the recipient state. For the allocation of income to different tax subjects in the two states, the OECD report assumes that the assessment in the recipient state is also relevant for the source state. Whoever is entitled subject to the treaty according to the law of the recipient state should also be able to avail oneself of the treaty benefits in the source state.²⁵ Accordingly, the tax subject qualification of the partnership in State P is crucial to the assumption by the authorities of State R that the partnership is a person resident in State P also for the purposes of the application of law in State R. Therefore, State R loses the right to taxation as source state according to article 12. Consequently, based on this reasoning, the Canadian authorities would have to follow the assessment of the private foundation under Austrian tax law and regard the gains from alienation

as achieved by a person resident in Austria. Canada would then lose the right to taxation.

The treaties of State R — here, Canada — are also applicable on the basis of the principles of the OECD partnership report if this state allocates the income to the partner of the partnership or, in the case under consideration, to Sommerer as the beneficiary of the Austrian private foundation. This, however, is not even mentioned by the authors of the OECD partnership report. Presumably the delegates did not deem it necessary, since in their opinion the taxation right of State R is excluded as a result of the application of the treaty with State P — here, Austria. From the point of view of State R, whose taxation is concerned, the application of the treaties entered into by State R on the level of the partner cannot impose any constraints to State R that go beyond tax exemption.

B. Allocation in Source State

The holders of the opinion described above, however, ultimately remained a minority in the OECD:

127. The majority, however, disagreed with that position. When taxing partner B, State R is taxing its own resident on income arising in its territory. Article 12 of the Convention does not affect taxation that is based on residence but only taxation that is based on source. When applying the Convention, State R may indeed consider, based on the principles developed in previous examples, that partner B may be considered to have received payment of his share of the royalties for the purposes of taxation in that State so that the limitation of Article 12 does not apply since that Article is only applicable where royalties arising in one State have been paid to a resident of the other State.

128. The Committee therefore decided that the Commentary on Article 1 be amended by adding the following paragraph thereto: “Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State’s right to tax the partnership on its income do not apply to restrict that other State’s right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State’s right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State.”²⁶

The peculiarity of case study 16 lies in the fact that the source state is identical with one residence state of the two recipients. This has prevented the majority

²⁴*Id.*

²⁵Lang, *The Application of the OECD Model Tax Conventions to Partnerships* (2000), p. 37.

²⁶OECD, *supra* note 22, at p. 46.

from consistently applying the principles otherwise developed for allocation conflicts.²⁷ In this case, it refuses to apply the treaty between State R and State P to the partnership resident in State P. According to this opinion, only the partner and his residence in State R are relevant. State R's treaties would then imply that State R maintains the right of taxation. Therefore, according to the majority's opinion regarding the solution of case study 16, the allocation of income in its source state is ultimately determinative — the royalties originate in State R and, under the tax laws of State R, must be allocated to the partners resident there. When applied to the case decided by the Canadian courts, this would mean that only the allocation of income according to Canadian law matters for the application of the treaty, since this involves gains from the alienation of Canadian companies. If one follows the opinion of the majority at the OECD, then Canada, as the residence state of Sommerer, can continue to exercise the right of taxation for the income allocated to him under Canadian tax laws.

The reason for this majority opinion at the OECD, which deviates from the otherwise applied principles, might well be discomfort from a tax policy perspective. The delegates cannot see why the assessment under treaty law in State R should depend on how State P treats the entity for tax purposes, and why its qualification as a taxable entity in State P should result in the loss of tax base for State R. This discomfort, however, should prompt the authors of the OECD partnership report to subject it to a critical review and eventually discard their otherwise applied premises,²⁸ according to which the application of the treaty in the source state should not depend on the allocation of income in the source state but on that of the other contracting state. By choosing a solution for case study 16 that is avowedly not in line with the otherwise applied principles, the authors of the OECD partnership report have questioned the validity of the principles they developed, which are built on shaky foundations.

I believe the more convincing arguments suggest that, in allocation conflicts, one should follow the judgment of the source state when the issue is whether the taxation right of this state is limited by a treaty.²⁹ After all, treaties themselves do not take an autonomous allocation decision. Instead, treaties can take full effect only when the persons obliged to pay tax under national law become the beneficiaries under treaty law. Therefore, for the application of the treaty in the source state, it should be determined who is the relevant recipient of the income under the tax law of this

state and in which state he is resident. Hence, for the assessment of the taxation right of source State R, the issue of where the partner of the partnership is resident is rightly relevant. Since the partner is resident in State R, State R is thus the relevant state of residence. The taxation right of State R depends on the constraints imposed to it by the treaties it has entered. When applied on the case decided by the Canadian courts, whether Canada was able to exercise a taxation right for the gains from the alienation depends on the treaties entered by Canada as the state of residence of Sommerer.

C. Allocation in Residence State

Just as the treaty application in the source state depends on the allocation of income under the law of the source state, the treaty application in the other state depends on whom the income must be allocated to under its tax law. The same applies to this state: Entitlement to treaty benefits can only be for those who are obliged to pay tax under the national law in that state and who therefore are the relevant taxpayers according to its tax law. Obviously, the OECD partnership report expresses the same opinion in its discussion of case study 16. As the state of residence of the partner of the partnership, State R is entitled to tax income allocated to the partner under the law of State R, and State P, as the state of residence of the partnership, is entitled to levy taxes on the income allocated to the partnership under the law of State P. Again, when applied to the case decided by the Canadian courts, Canada may tax the gains from the alienation if they are allocated to Sommerer under Canadian law, and Austria may tax them if they are allocated under Austrian law to the private foundation resident in Austria.

As a result, for the purposes of taxation in Canada, it is not relevant whether these are gains from the alienation of Canadian shares — as in the case under consideration — or whether these are shares of companies resident in other states. In the last-mentioned situations, Canada is not both the source state and the state of residence but *only* the state of residence. In case of allocation of gains from the alienation of foreign shares, the fact that Sommerer is resident in Canada would mean under Canadian law that the treaties entered into by Canada also apply regarding this income.

Another question is whether the application of the Canadian treaties in all these cases would mean that Canada's right to taxation would be maintained after the application of the treaty. In case study 16, the authors of the OECD report implicitly express this opinion. Case study 16, however, is based on the assumption that the offices of the partnership in State P are a permanent establishment, and that the royalties cannot be attributed to a PE in State R. If the royalties are to be attributed to the PE in State P, the question could arise as to whether the partnership also procures corporate gains for its partners as defined in article 7 of the

²⁷Similar discussion on case study 17 of the OECD report: critical comments by Lang in "Qualifikations- und Zurechnungskonflikte im DBA-Recht," *IStR* 2010, 114 (116).

²⁸More detailed analysis by Lang, *supra* note 25, at 90 et seq.

²⁹See Lang, *IStR* 2000, 132 et seq.

OECD model, and that the gains from alienation in the state of residence should thus be treated as defined in article 13(2) of the OECD model. If the exemption method is applied, State R would then lose its right to taxation. This consideration, however, could only apply if one also assumes that the PE of the partnership in State P is *also* regarded as the PE for the partner resident in State R.³⁰

In the cases decided by the Canadian courts, however, based on the opinion held by the OECD, which I also regard as conclusive in this case, there can be no doubt as to Canada's right to taxation if the gains from alienation had been allocated to Sommerer under Canadian law: The private foundation is arguably not an enterprise within the meaning of article 7 of the OECD model and cannot therefore have a PE under treaty law. Hence, there can be no question about whether a PE of the private foundation also gives Sommerer a PE. Therefore, the application of Article XIII(5) of the Austria-Canada treaty and hence taxation in Canada remains.

D. Credit Taxes in the Residence State?

In case study 16, the OECD partnership report also discusses whether the State R is obliged to credit a tax levied on the partnership in State P:

129. Since State R's right to tax partner B on his share of the income of the partnership derives from the partner's residence in that State, it follows that State R must also give the benefits of Article 23 to partner B. The fact that the partnership has a permanent establishment in State P is not relevant in that respect since, as discussed in subsection b), the tax levied by State P will still have been levied in accordance with the provisions of the Convention since State P is allowed to tax partnership P as its resident. The application of Article 23 by State R may, however, raise some difficulties because State P will levy its tax on the partnership rather than on the partners and because that tax may be levied both when the income is realized and when it is distributed (that is, through a withholding tax on the distribution which State P may treat as a dividend). These difficulties are examined below in relation to example 18.³¹

These considerations are resumed in case study 18. This case study also refers to a partnership that is considered a tax subject in its state of residence P but is deemed transparent in its partner's state of residence R, to whom the income is allocated in the latter as a result:

139. The third difficulty concerns only States that apply the credit method and relates to the fact that both States impose tax upon the same income, but on different taxpayers. The issue is therefore whether State R, which taxes partner A on his share in the partnership profits, is obliged, under the Convention, to give credit for the source tax that is levied in State P on partnership P, which State P treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that State R flows through the income of the partnership to the partners for the purpose of taxing them, it should be consistent and flow through the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P is ignored for purposes of taxing the share in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit.³²

It is highly questionable whether the provisions of the OECD model support this opinion. In case study 18, the authors of the OECD report believe that indirect crediting is admissible. In particular, the partner's state of residence would have to credit a tax levied on the partnership to the tax of the partners. Articles 23 A(2) and 23 B(1) of the OECD model, however, require that the tax is levied in both states on the *same* taxpayer. Although several tax law systems provide for an indirect credit, this is not the case in article 23 of the OECD model.³³

As noted above, the cases that had to be decided by the Canadian courts did not involve any corporate gains or a PE in Austria. Therefore, the treaty provisions patterned on articles 7 and 13(2) of the OECD model were not relevant and thus no distribution rules could apply, for which the Austria-Canada treaty provides for the credit method. Nevertheless, the formulation mentioned by the authors of the OECD report in case study 16 could suggest that the state of residence, regardless of the applicable distribution rule, would be obliged to introduce measures to avoid double taxation simply based on article 23 of the OECD model.

Based on this opinion, the fact that the gains from alienation can be taxed in Austria would then oblige Canada to credit any Austrian tax. The Canadian authorities would then have to understand the phrase "tax payable under the law of Austria and in accordance with this Convention" in Article XXIII(1)(a) of the Austria-Canada treaty from the point of view of the Austrian law practitioner, something that the wording of this provision suggests just as little as in the

³⁰Further material on this in Lang, "CFC-Regelungen und Doppelbesteuerungsabkommen," *IStR* 2002, 717 (721).

³¹OECD, *supra* note 23, at p. 46.

³²*Id.* at pp. 49-50.

³³More detailed analysis in Lang, *supra* note 25, at 97 et seq.; critical comments also by Kubik, *ZFS* 2012, 168.

cases of qualification conflicts.³⁴ In the case under consideration, there are even fewer arguments in favor of this opinion, since Article XIII(5) of the treaty — contrary to, for example, Article VII — clearly allocates the exclusive taxation right for gains from alienation to Canada as the state of residence of Sommerer. This is incompatible with an opinion according to which, for the purposes of Article XXIII of the treaty, the Canadian authorities would at the same time assume that the income can be taxed in Austria “in accordance with the Convention” and that the Austrian tax will thus have to be credited.³⁵

³⁴Critical comments also in connection with an Express Antwort Service ruling by the Federal Ministry of Finance going in the other direction by Lang, “Zurechnungskonflikte im DBA-Recht: Unterschiedliche Auffassungen des österreichischen Finanzministeriums und der OECD,” *IStR* 2012, 857 (860 et seq.).

³⁵According to the opinion preferred by Kubik (*ZFS* 2012, 168), Article XXI of the treaty would be applicable from a Canadian point of view. If one regards Austria as the source state according to Article XXI(2), this could result in an obligation to

IV. Concluding Summary

The analysis carried out here has shown that the reasoning of the Canadian courts is not conclusive, because under the treaty Canada, in case of the allocation of the gains from alienation to Canadian resident Sommerer, would not have been allowed to levy any income tax. One must nevertheless thank the courts for undertaking the effort to interpret the treaty, although in their opinion the income was allocated to Sommerer under Canadian tax law. The deliberations of the courts in this case should prompt law practitioners and scientists around the world to acquire a deeper understanding of the issue of treaty application in allocation conflicts, and to critically review the corresponding solutions developed by the OECD. ♦

credit Austrian taxes. Kubik is also doubtful, however, as to whether the treaty imposes indirect crediting.

(Footnote continued in next column.)