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# 2008 OECD Model: Conflicts of Qualification and Double Non-Taxation

**The 2008 Update of the OECD Model modified Para. 32.6 of the Commentary on Art. 23 of the OECD Model. Para. 32.6 was added in 2000 and deals with double non-taxation arising from conflicts of qualification. The changes to Para. 32.6, although minor, deserve careful analysis because the issue of qualification conflicts resulting in double non-taxation is highly controversial. This article examines the changes to Para 32.6 and analyses the policy and legal considerations relating to the approach taken in Para. 32.6.**

## 1. Changes to the OECD Commentary

The 2008 Update of the OECD Model Tax Convention and its Commentary on Arts. 23 A and 23 B slightly revised, among other things, Para. 32.6 of the Commentary which deals with double non-taxation arising from conflicts of qualification. The changes to the wording of Para. 32.6 are minor, but since discussions on conflicts of qualification and double non-taxation are highly controversial, these changes deserve a careful analysis.

Para. 32.6 was added to the OECD Commentary in 2000 and, after its revision in 2008, reads as follows (emphasis added):

> The phrase "in accordance with the provisions of this Convention, may be taxed" must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which *it would otherwise have had the right to tax*, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as *to have the right to tax* that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

The original 2000 version used the phrase "have taxed" instead of "have had the right to tax" and the phrase "to tax" instead of "to have the right to tax". The drafters of the 2008 Update found the phrase "it would otherwise have taxed" to be "unduly restrictive since there are cases where the source State considers that the Convention prevents it from taxing an item of income but that item of income would not have been 'otherwise taxed' in that State because the item of income is not taxable under the State's domestic law".[1] According to Raffaele Russo, the Commentary was amended to clarify that Art. 23 of the OECD Model does not impose on the residence state the obligation to grant relief when the source state considers that the tax treaty prevents it from taxing, regardless of whether or not the source state would tax the income under its domestic law.[2]

## 2. Policy Considerations

This question is part of a larger discussion. The 2000 Commentary took the position that qualification conflicts can be solved under the existing OECD Model by means of interpreting Art. 23 of the Model. The Commentary followed an approach already taken in the OECD Partnership Report,[3] which was originally developed by Jean-Marc Dery and David Ward[4] and further elaborated on by John Avery Jones et al.[5] According to this approach, the phrase "in accordance with the provisions of this Convention" in Arts. 23 A and 23 B is crucial. The drafters of the 2000 Commentary argued that this phrase requires the residence state to grant relief from double taxation in conflicts of qualification resulting from differences in domestic law. In such a case, the residence state should be bound by the qualification of the source state.[6] Since the drafters of the 2000 Commentary considered qualification conflicts leading to double taxation and qualification conflicts leading to double non-taxation as "mirror situations", they dealt with the latter type of qualification conflicts as well. In their view, the phrase "in accordance with the provisions of this Convention" should also be relevant to the latter type of conflicts: the residence state is not obliged to exempt income which the source state does not tax because it is prevented from doing so under a tax treaty provision, as

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1. OECD, *Draft contents of the 2008 update to the Model Tax Convention*, Part I, as referred to in van Raad, Kees, *Materials on International and EC Tax Law 2008/2009*, Vol. I (2008), at 360.
2. Russo, Raffaele, "The 2008 OECD Model: An Overview", *European Taxation* 9 (2008), at 459, 464 et seq.
3. OECD, *The Application of the OECD Model Tax Convention to Partnerships* (1999), Para. 102 et seq.
4. Dery, Jean-Marc and David Ward, National Report on Canada on Subject I: Interpretation of double taxation conventions, in *Cahiers de droit fiscal international*, Vol. LXXVIIIa (1993), at 259, 281 et seq. (47th Congress of the International Fiscal Association, Florence, 1993).
5. Avery Jones, John F. et al., "Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization", *European Taxation* 1 (1996), at 118, 141 et seq.
6. For a critical discussion of this approach, see Lang, Michael, *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), at 10 et seq.

it has to be understood under the domestic law of the source state.[7]

The 2008 Update extends this approach to cases where the source state already refrains from levying tax under its domestic law, but would in any case have been prevented from levying tax under the allocation rules of the tax treaty, understood in light of its domestic law. At first sight, this position sounds reasonable from a policy perspective. Why should it make a difference whether or not the source state would levy tax under its domestic law if that state is prevented from levying tax under the tax treaty? The result is identical in both situations. Even if tax was due under the domestic law of the source state, the tax treaty does not permit the tax to be levied, and the different qualification by the residence state under its domestic law would lead to the double non-taxation that the Commentary wants to prevent.

This view is not completely obvious, however. One could also argue that, in such a situation, the double non-taxation was not caused by a different qualification of the same tax treaty rules by the two governments. If the source state had applied the same tax treaty rules as the residence state, double non-taxation would also have arisen due to the policy decision taken by the source state not to tax. So why should it make a difference whether the source state would be entitled to tax if that state had already decided not to tax domestically? If double non-taxation is legitimate where both states apply the same tax treaty rule, but the residence state is prevented from taxing under the treaty and the source state does not levy tax domestically, then it is difficult to understand why double non-taxation becomes illegitimate just because the source state would have applied a different tax treaty rule if it had to apply the treaty.

In addition, one should also take into account the mirror situation. For qualification conflicts where both countries, under their domestic laws, feel obliged to apply different tax treaty rules which confirm the taxing right of each state, the OECD Commentary has not changed the position taken in 2000. The Commentary still requires actual double taxation that is caused by a qualification conflict. The mere existence of a qualification conflict is not sufficient. In a situation where the source state does not levy tax, although it could under its domestically influenced interpretation of the tax treaty, the residence state that is entitled to tax under its understanding of the treaty's allocation rules is not obliged to exempt the income under Art. 23 A of the OECD Model. If the approaches were balanced, a mere qualification conflict making double taxation or double non-taxation possible should be sufficient in both situations or in neither of them. Either in both cases or in neither case should it be relevant whether a tax liability exists under the domestic law of the source state.

## 3. Legal Considerations

It is difficult to say whether Art. 23 A of the OECD Model provides a sound legal basis for the position taken in the 2008 Update of the Commentary. Even regarding the approach taken in the 2000 Commentary, it is debatable whether the approach is covered by Art. 23 A. It is doubtful whether the wording of Art. 23 A, which was not changed in 2000 or in later years, expresses the meaning intended by the drafters of the 2000 Commentary.[8] It is often contested that the phrase "taxed ... in accordance with the provisions of the Convention" actually contains a reference to the law of the source state. Instead, the phrase can be understood to mean that it is up to the tax authorities of the residence state to judge either independently from the treaty or, as an applying state in accordance with Art. 3(2) of the OECD Model, based on the understanding familiar to its national law whether the source state has the taxing right in a specific situation. If the position expressed in the 2000 Commentary is not covered by the wording of Art. 23, it cannot be considered relevant at all. However, the authors who regard the 2000 Commentary to be relevant for the interpretation of Art. 23 assume either that the position taken in the 2000 Commentary is covered by the wording of the OECD Model or that the intention of the drafters is explicit enough to replace the clear wording of the OECD Model. Some of these authors consider the 2000 Commentary relevant only for the interpretation of the treaties negotiated or concluded since 2000; others go so far as to take the 2000 Commentary into account when interpreting older treaties.

Additional difficulties are caused by the fact the 2000 Commentary considers the source state's qualification relevant only if the qualification is influenced by the source state's domestic law. If, however, the qualification conflict has its root in a different interpretation of the facts of the case or in a different interpretation of the treaty terms that must be interpreted without reference to domestic law, the residence state may not be bound by the source state's qualification. This distinction seems to be based on Art. 3(2) of the OECD Model. Under that provision, any terms not defined in the treaty must, "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". The meaning of Art. 3(2) of the OECD Model is greatly disputed. Some authors put heavy emphasis on the phrase "unless the context otherwise requires" and regard the provision as confirming the obligation to interpret the treaty as much as possible autonomously without reference to domestic law.[9] Others take the opposite position and almost ignore that phrase; they therefore feel obliged, as a general rule, to interpret undefined treaty

7. Paras. 32.1 to 32.5 of the 2000 OECD Commentary.

8. For a discussion of these arguments, see Lang, Michael, General Report on Subject I: Double non-taxation, in *Cahiers de droit fiscal international*, Vol. 89a (2004), at 21, 95 et seq. (58th Congress of the International Fiscal Association, Vienna, 2004).

9. See Lang, Michael, 'Die Bedeutung des originär innerstaatlichen Rechts für die Auslegung von Doppelbesteuerungsabkommen (Art. 3 Abs 2 OECD-MA)', in Burmester, Gabriele and Dieter Endres (eds.), *Außensteuerrecht, Doppelbesteuerungsabkommen und EU-Recht im Spannungsverhältnis, Festschrift für Helmut Debatin* (1997), at 283 et seq.

terms in accordance with domestic law.[10] Still others take a position in between these two by, for example, interpreting the term "requires" as taking into account the context only if that is supported by strong arguments.[11]

A recent discussion between Heinz Jirousek and Andrew Dawson illustrates the above difficulties.[12] They gave as an example the case of a CEO of a corporation who is a resident of State A. The corporation has its seat and place of effective management in State B. They assumed that the CEO exercises her activities partly in State A and partly in State B. According to the approach taken by the Austrian tax authorities, the qualification of the CEO's remuneration under Art. 15 or 16 of the OECD Model depends on domestic law.[13] On the other hand, the UK tax authorities are of the opinion that if the CEO is on the board of directors and some of her responsibilities are in her capacity as a director and some in her capacity as the CEO running the company on a day-to-day basis, the activities must be split based on this distinction. The UK tax authorities would apply Art. 16 of the OECD Model to the activities performed in her capacity as a member of the board. Under the approach taken by the UK tax authorities, this would be regarded as a question of treaty interpretation, regardless of the qualification under domestic law. Thus, the Austrian tax authorities would apply Art. 23 of the OECD Model to prevent either double taxation or double non-taxation, but the UK tax authorities would simply consider any interpretation different from theirs to be wrong. In their view, Art. 23 of the OECD Model would not apply.

The authors who accept the view that the approach taken in the 2000 Commentary is supported by the wording of Art. 23 of the OECD Model should not have a problem extending this approach to situations where the source state does not levy tax domestically and also thinks that it is prevented from doing so under the tax treaty. Under this approach, Art. 23 A(1) of the OECD Model (exemption in the residence state) is applicable only if the income "may be taxed" in the source state. A person "may be taxed" in the source state "in accordance with the provisions of this Convention" only if the tax treaty does not prevent that state from doing so. Whether tax would actually be levied in the source state if the treaty provisions had not been applicable is obviously not relevant. In other cases of qualification conflicts, Art. 23 A(1) provides an exemption in the residence state, regardless of whether or not the source state has exercised its taxing right under the treaty.

If, however, the wording of Art. 23 A(1) is broad enough to allow the residence state to refuse to exempt the income if the source state, under its domestic law interpretation, is prevented from taxing the income, regardless of whether tax would otherwise be levied there, the same approach should be followed in the mirror situation. If the source state, under its domestic interpretation of the treaty terms, is able to exercise taxing rights but refrains from doing so domestically, the income still "may be taxed" in "accordance with the provisions of this Convention". Thus, a residence state that, under its domestic law interpretation, takes the position that the income falls under a different allocation rule and that therefore it may also exercise taxing rights should be prevented from doing so since the income "may be taxed" in the other state. There is no reason not to apply Art. 23 A(1) of the OECD Model in that situation as well, once one has accepted the position in the 2008 Update for the mirror situation.

## 4. Conclusion

**The approach taken in the 2000 Commentary had received mixed reviews. It has been argued that the approach lacks a legal basis under Art. 23 A(1) of the OECD Model and that the approach might be regarded by source states as an invitation to extend their taxing rights under the treaty simply by changing either the domestic law as such or merely its interpretation. Residence states that are not willing to give up their taxing rights, however, may always argue that they do not have to follow the source state's position if they intend to maintain their taxing rights based on an autonomous interpretation of the treaty. They can consider themselves to be required to do so by the "context" of the treaty. As a result, the number of cases of double taxation might even increase. Despite these objections, the OECD Committee on Fiscal Affairs has not reconsidered its approach and, in the 2008 Update, it even extended the scope of that approach in order to be able to prevent double non-taxation in certain other situations. The authority for that approach is weak since the 2008 Update has not broadened its interpretation of Art. 23 A(1) of the OECD Model in general, but only for situations where it is in the interest of the tax authorities to generate additional tax revenues.**

It must not be overlooked that the approach already taken in the 2000 Commentary, which has been confirmed and developed further in the 2008 Update, tries to resolve a problem caused by other positions in the OECD Commentary. The OECD has neither abolished the reference to domestic law in Art. 3(2) of the OECD Model nor made it clear that the phrase "unless the context otherwise requires" should be understood as broadly as possible. The fewer the cases where domestic law is used to interpret treaty terms, the greater the probability that both states will try hard to interpret the treaty in its context and thereby reach an understanding of a treaty term that can be accepted in common. This

10. See Avery Jones, John F. et al., "The Interpretation of Tax Treaties With Particular Reference to Article 3(2) of the OECD Model", [1984] *British Tax Review* 107 et seq.
11. For a discussion, see Lang, supra note 8, at 97 et seq.
12. See Simader, Karin, "International Tax Law Summer Conference in Rust: Taxation of CEO Income – Case Study", 11 *Steuer & Wirtschaft International* 531 (2008).
13. Id. at 531.

would be best to avoid both double taxation and double non-taxation. Of course, it may be burdensome to focus both on definitions and on achieving interpretation results by taking into account the wording and history of a provision, its context and its object and purpose.[14] However, making use of the traditional means of interpretation is common to us lawyers whenever we interpret domestic law terms, which quite often are also undefined. It is not desirable to forget our methodology when it comes to interpreting tax treaty provisions.

14. See Lang, Michael and Florian Brugger, "The Role of the OECD Commentary in Tax Treaty Interpretation", 23(2) *Australian Tax Forum* 95 (2008).