Chapter 7: Credit Method and Different Taxes on Income and on Capital

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7.1. The problem to be solved

The OECD Model Tax Convention on Income and on Capital (OECD Model) applies to both taxes on income and taxes on capital imposed by contracting states as covered in article 2 of the OECD Model.[1] It is possible that one or both of the contracting states include more than one tax on income or on capital within the list of taxes covered by the treaty in article 2(3). The same situation may occur when additional taxes on income or on capital are introduced after the signature of the treaty and are, therefore, covered under article 2(1) and (2), despite not being mentioned in article 2(3). According to article 2(4), identical or substantially similar taxes to the ones listed in article 2(3), which are later introduced in addition or in place of existing taxes, are also covered under the treaty. If article 2, in particular under article 2(3), covers taxes, whose inherent nature is not that of a tax on income or on capital, or at least not according to article 2(1) and (2), they still have to be treated as taxes on income and on capital for treaty purposes, including the application of the double taxation relief method provided in article 23 of the OECD Model.[2]

This chapter analyses the functioning of the credit method in cases where one state levies more than one tax. It is divided into four sections: section 7.2. discusses the current state of the debate respecting the creditability of taxes when there is more than one tax in one of the contracting states and the manner in which the credit should apply in those situations. Section 7.3. analyses the interpretation of article 23B(1) of the OECD Model and the difficulties that arise when distinguishing between taxes on income and on capital. Section 7.4. analyses scenarios where there is only one tax in each of the contracting states with different tax bases and rates and then compares them to situations where there is more than one tax in the residence state. Finally, section 7.5. concludes this chapter.

7.2. Current state of the debate

7.2.1. Multiple taxes in the source or in the residence state

There are two main problems when considering the application of the credit method and the existence of more than one tax in one of the contracting states. The first problem refers to the possibility of having more than one tax covered for the application of the credit in article 23B of the OECD Model. If the answer to this first issue is positive, then the second problem is how the computation of the credit should take place. These two questions are discussed in this section, taking into account the experience of some jurisdictions.

On 6 November 2019, the Supreme Administrative Court of Portugal ruled on whether the German income tax, church tax and solidarity surcharge, paid by a Portuguese resident on his employment income perceived in Germany, were creditable against his income tax liability in Portugal on the same income.[3] The Portuguese tax administration rejected the creditability of the German church tax and solidarity surcharge, granting only a credit for the income tax. The tax authority argued that neither of the former taxes were listed in article 2 of the treaty and that equivalent taxes that could be credited did not exist in Portugal.

The court rejected the tax administration's argument and found that both the church tax and solidarity surcharge were taxes covered under the Germany-Portugal Income and Capital Tax Treaty (1980).[4] The decision also emphasized that foreign taxes do not need to have the same or a similar nature to one of the taxes levied in Portugal. Thus, the court agreed that the three German taxes were creditable against the Portuguese personal income tax (PIT).

In a converse situation, the Administrative Court of Luxemburg reached a different conclusion in its decision on 17 January 2006.[5] In this case, a Luxembourg bank received interest income arising from Spain and subject to withholding tax therein. The bank claimed a credit for the Spanish tax against its corporate income tax (CIT) and municipal business tax (MBT); both taxes covered

1. *OECD Model Tax Convention on Income and on Capital* art. 2 (21 Nov. 2017), Treaties & Models IBFD.
2. P.B. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 Tax L. Rev. 1, p. 13 (1982); A.J. Martín Jiménez, *Defining the Objective Scope of Income Tax Treaties: The Impact of Other Treaties and EC Law on the Concept of Tax in the OECD Model*, in *The Concept of Tax* p. 279 (B. Peeters et al. eds., IBFD 2005), Books IBFD.
3. PT: STA [*Supremo Tribunal Administrativo*] [Supreme Administrative Court], 6 Nov. 2019, Case 041/12.5BEALM, Case Law IBFD.
4. *Ger.-Port. Income and Capital Tax Treaty* (1980), Treaties & Models IBFD.
5. LUX: CA [*Cour Administrative*] [Administrative Court], 17 Jan. 2006, Case 20316 C, Case Law IBFD.

under article 2 of the Luxembourg-Spain Income and Capital Tax Treaty (1986).[6] The tax authorities rejected the creditability of the foreign tax against the MBT, granting a credit only on the CIT liable in Luxembourg.

The court, in the first instance, ruled in favour of the taxpayer, and also for the creditability of the foreign tax against the MBT. This decision was appealed by the tax administration, which argued that it was not the intention of the contracting states to include the MBT as a tax covered for the purposes of the credit, a position that allegedly is confirmed by the lack of a detailed rule in the treaty regarding the order in which the foreign tax should be credited against the taxes in Luxembourg. In the second instance, the court made reference to the Commentary on Article 23 of the OECD Model,[7] which determines that when there are no detailed rules in the treaty for the computation of the credit, it is up to the domestic law to determine such calculation. Thus, since under domestic law the credit for foreign taxes proceeds only against CIT in this case, no credit for foreign taxes could be granted against MBT. This decision was met with criticism, and some authors argued that the court should have applied an autonomous interpretation of the credit article, resorting to the domestic law only to "set out the mechanics of the credit" without introducing further limits.[8]

In a similar decision in Germany, the Hessian Tax Court had to determine whether Canadian withholding tax on dividends was creditable against the local business tax (*Gewerbesteuer*).[9] In this case, a German GmbH received dividends from a 0.22% holding in a Canadian company. From 2008 to 2010, the Canadian company withheld taxes upon the distribution of dividends. For German corporate income tax purposes, dividend income was exempted and, therefore, the tax liability amounted to zero; however, this income was taxed under the local business tax. Thus, the dividends were subject to double taxation: once in Canada with withholding tax and once in Germany with local business tax. For this reason, the German taxpayer credited the Canadian withholding tax against its tax liability in Germany, a position that was rejected by the tax administration.

The court determined that the double taxation relief article in the Canada-Germany Income and Capital Tax Treaty (2001)[10] did not make any distinction between the different taxes on income, and thus, those taxes listed in article 2(3) are to be considered in this way.[11] Furthermore, the court established that the local business tax, regardless of its territorial character, shall be taken into account for providing credit for foreign taxes, insofar as its tax base included items of income realized abroad, for example, dividends in this case.[12] Regarding the methodology for the application of the credit, the court stated that the same criteria set out for the corporate and individual income tax should be applied to the trade tax.[13] However, because the only tax liability in the residence state, regarding the income obtained in Canada was the German local business tax, the court did not touch upon the specific functioning of the credit when there is more than one tax in the residence state regarding income derived in the source state.[14]

The same issue was studied by the Austrian Federal Ministry of Finance (*Bundesministerium für Finanzen,* BMF) in 1992, which had to determine whether foreign taxes were creditable against the Austrian trade tax (*Gewerbesteuer*).[15] One of the examples provided by the BMF was an Austrian real estate company that leases several of its buildings, located in Italy, to an Italian hotel operating company. The income obtained in Italy amounts to EUR 1,000,000 (EUR 1,500,000 for renting the buildings minus EUR 500,000 of interest expenses for making renovations on them) and it is subject to Italian tax of EUR 400,000 (40%), from which only EUR 300,000 were credited against the corporate income tax (30%) in Austria at that time. The exceeding part amounts to EUR 100,000. The case dealt with the trade tax based on trade income (*Gewerbeertag*). Thus, the maximum creditable amount was calculated, taking into account the foreign trade income (the rental income and the interests in this case), which amounted to EUR 1,500,000 and multiplying it first by 4.5% (tax base) and then by 320% (assessment rate); that is, EUR 216,000. Thus, the exceeding EUR 100,000 was creditable against the trade tax.

In the reasoning of the BMF, the foreign tax is creditable against the trade tax only when the maximum tax credit of the Austrian individual or corporate income tax was exceeded. However, it is not clear why the BMF determined that the creditability of foreign taxes against the trade tax should take place only once they have surpassed the maximum creditable amount of individual or corporate income taxes.[16]

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6. *Lux.-Spain Income and Capital Tax Treaty* (1986), Treaties & Models IBFD.
7. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23* (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 23* (2017)].
8. C. Joosen & A. Taferner, *Getting the (Foreign Tax) Credit One Deserves?*, 46 Eur. Taxn. 4, p. 181 (2006), Journal Articles & Opinion Pieces IBFD.
9. DE: FG [*Hessisches Finanzgericht*] [Hessian Finance Court], 26 Aug. 2020, Case 8 K 1860/16.
10. *Can.-Ger. Income and Capital Tax Treaty* (2001), Treaties & Models IBFD.
11. Case 8 K 1860/16 (26 Aug. 2020), paras. 36 and 38.
12. Id., at para. 41. *See also*, regarding the extraterritoriality of subnational taxes covered under tax treaties, D. Eberhardt, *Zur Abkommensrechtlichen Verpflichtung Der Anrechnung Ausländischer Steuern Auf Die Gewerbesteuer*, 28 IStR 5, p. 181 (2019); and P. Arginelli, *L'Italia Permette La Detrazione Delle Imposte Estere Dall'Irap, Oltre Che Dall'Ires?* 2 Novità fiscali 2, p. 19 (2011).
13. Case 8 K 1860/16 (26 Aug. 2020), paras. 42, 43 and 52.
14. Id., at para. 61.
15. AT: BMF [Ministry of Finance], 3 Nov. 1992, Case 04 101/114-IV/4/92. The Austrian trade tax was based on three different tax bases: (i) trade income (*Gewerbeertrag*); (ii) trade capital (*Gewerbekapital*); and (iii) total wages (*Lohnsumme*). From these three bases, only the latter succeeded in the current Austrian municipal tax.
16. S. Haas, *Anrechenbarkeit ausländischer Steuern auf die Kommunalsteuer*, 30 SWI 3, p. 128 (2020).

The foregoing decisions recognized that the credit method was applicable in respect to more than one tax in one of the contracting states. It applies when there are various taxes in the source state susceptible to be credited in the residence state, as in the Portuguese case.[17] It also applies when regarding a foreign tax and more than one tax in the residence state, as in the other cases described.[18] All these decisions illustrated that the various taxes, levied in the residence state, should be taken into account when applying the credit method. However, for different reasons, in some instances, the credit was not provided, for example, lacking the implementation of the rules in the case of Luxembourg.

However, the application of the credit method to more than one tax in one of the contracting states is not subject to the domestic law of the contracting states. Indeed, article 2 defines the substantial scope of the treaty in an autonomous way, and the taxes covered therein must be taken into account when applying the credit article in those treaties patterned after article 23B of the OECD Model. The domestic legislator cannot limit this treaty obligation arguing the absence of domestic rules in respect of taxes, which are, nevertheless, covered by the treaty. Although the OECD Commentaries mention that "[a]rticle 23B sets out the main rules of the credit method, but does not give detailed rules on the computation and the operation of the credit",[19] this does not mean that the domestic legislator is free to provide detailed rules and to make the method article applicable or not. The rules in article 23B of the OECD Model are not very detailed, but they are detailed enough to be applied directly, if the domestic legislator fails to introduce specific rules, which of course have to be in line with the spirit of article 23B of the OECD Model.

The introduction to the Commentary on the OECD Model defines double taxation as the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter for identical periods.[20] This definition is interpreted as demanding the comparability of the foreign and domestic taxes for the purposes of eliminating double taxation.[21] However, in the abovementioned cases, the courts had decided that the comparability of the taxes was not relevant. Since comparability is not relevant under article 23B of the OECD Model, it is understandable that the courts did not consider it as a criterion.

7.2.2. Operation of the credit when there are multiple taxes in the residence state: Prioritization of specific taxes?

In the judgment rendered by the Administrative Court of Luxembourg,[22] the application of the treaty to the MBT was accepted, because the MBT was listed in article 2 of the Luxembourg-Spain Income and Capital Tax Treaty (1986). However, the Court established that the allegedly lack of a specific rule for the credit of foreign taxes against the MBT in the treaty, and the absence of such provision under the domestic law of Luxembourg, prevented the granting of the credit of foreign taxes against the MBT.

This argument, as already pointed out, does not seem convincing. The absence of a specific domestic provision does not remove the treaty obligation of crediting foreign taxes against domestic ones, insofar as these taxes are covered in article 2. In these cases, the credit should be granted directly by the application of the treaty itself or, as argued by some authors, making use of the domestic provisions for the credit on regular taxes, such as the PIT or CIT, but applying it to the other taxes covered.[23] Moreover, making a comparison with other treaties, in order to unveil whether or not the credit method of article 23B(1) of the OECD Model applies to more than one tax, might lead to different results. There are treaties in which the wording of the credit article excludes certain taxes from its application; for example, the Germany-Switzerland Income and Capital Tax Treaty (1971) explicitly excludes from its scope the German trade tax.[24] Alternatively, there are treaties in which the credit article makes explicit reference to certain taxes covered in article 2; for example, the Italy-United States Income Tax Treaty (1999) provides for the creditability of part of the Italian regional tax on productivity (IRAP).[25]

The comparison to other tax treaties is not a convincing argument to interpret article 23B(1) of the OECD Model. As already noted by the Administrative Court of Luxembourg, each tax treaty constitutes an autonomous set of rules[26] and is the result of separate bilateral negotiations. One treaty partner might request a specific clarification in a treaty provision, whereas another treaty partner does not. Different wording of provisions does not necessarily allow to conclude that their content is different. Thus, for those tax treaties patterned after the OECD Model, the interpretation of the credit article should rely on the wording, the context, the object and purpose, and the history of article 23B of the OECD Model, but not on its comparison with other bilateral treaties.

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17. Case 041/12.5BEALM (6 Nov. 2019).
18. Case 20316 C (17 Jan. 2006); Case 8 K 1860/16 (26 Aug. 2020); and Case 04 101/114-IV/4/92.
19. Para. 60 *OECD Model: Commentary on Article 23B* (2017).
20. Para. 1 *OECD Model: Introduction* (2017).
21. M Helminen, *General Report*, in *The Notion of Tax and the Elimination of International Double Taxation or Double Non-Taxation* p. 45 (IFA Cahiers vol. 101B, Sdu Uitgevers 2016), Books IBFD.
22. Case 20316 C (17 Jan. 2006).
23. Arginelli, *supra* n. 12, at p. 20; Joosen & Taferner, *supra*. n. 8, at p. 181; J Rieck, *Höchstbetragsermittlung bei der Anrechnung ausländischer Steuern auf die Gewerbesteuer*, 28 IStR 15, p. 590 (2019).
24. *See* art. 24(1)(2) *Ger.-Switz. Income and Capital Tax Treaty* (1971), Treaties & Models IBFD. *See also* J.D. Becker & T. Loose, *Zur Anrechnung Ausländischer Quellensteuern Auf Die Gewerbesteuer*, 21 IStR 2, p. 61 (2012).
25. *See* art. 23(2)(c) *It.-US Income Tax Treaty* (1999), Treaties & Models IBFD. *See also* Arginelli *supra* n. 12, at p. 20.
26. Case 20316 C (17 Jan. 2006).

Some authors argue in favour of the creditability of foreign taxes against more than one tax in the residence state. With regards to the way in which the credit should operate in these situations, the most accepted theory advocates for prioritizing or ranking the taxes liable in the residence state in respect to their comparability to the foreign tax.[27] According to this theory, only the excess, not creditable against the most similar tax, usually PIT or CIT, would be creditable against other taxes covered, for example, the German local business tax or the Austrian municipal tax. Applying the credit in such a way would entail a comparison of the foreign and domestic taxes to determine their creditability.

However, such a requisite is not demanded by article 23B(1) of OECD-patterned treaties.[28] Article 23B does not draw any distinction between the different taxes on income or on capital in the source and residence states. Thus, there is no reason to prioritize one tax over the other according to their comparability. This would conflict with the wording of article 23B and may lead to situations in which certain taxes are not creditable because they are not comparable.[29]

Other authors argue that due to the lack of guidance regarding the creditability of foreign taxes against various taxes in the residence state, the taxpayer should have the option to choose the most favourable solution.[30] However, there is no indication that the treaty grants an option to the taxpayer. Since the rule of law is a prevailing principle in many countries, it cannot be assumed that the OECD Model, which serves as a toolbox for OECD member countries and beyond, leaves it to the taxpayer to decide which tax of the residence state should be reduced by deducting foreign taxes.

7.3. Taxes on income versus taxes on capital

7.3.1. The interpretation of article 23B(1) of the OECD Model

The relevant provision is article 23B(1) of the OECD Model:

> Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall allow:
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> 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.

Article 23B is an important provision of the OECD Model and has to be regarded in connection with the other provisions. Article 23B(1) mentions the terms “tax on the income” and “tax on the capital” and is, therefore, closely linked to article 2 of the OECD Model that deals with “taxes on income and on capital”. Article 2 of the OECD Model decides which taxes are covered under the treaty. It can be expected that for all taxes that are covered under the OECD Model, article 23B provides for relief of double taxation. Therefore, article 23B of the OECD Model covers all taxes that are already covered under article 2 of the OECD Model. There is no reason to believe that Article 23B of the OECD Model limits the scope of the Model Convention.

The wording and the structure of this provision teaches several lessons. Already at first sight, it is obvious that there is a clear distinction between income and capital, as well as between tax on the income and tax on the capital. Therefore, we have to qualify each tax that is covered under the OECD Model, according to its article 2, either as a tax on the income or as a tax on the capital. There is no third category. Since all taxes that are covered under article 2 of the OECD Model also fall under article 23 of the OECD Model, no such tax may be left over.

Article 2 of the OECD Model may cover more than one tax on income and more than one tax on capital. Many times, the list of taxes under article 2(3) of the OECD Model is quite long, and each of these taxes has to qualify either as tax on income or on capital. This is also true for the taxes introduced after the signature of a convention, if they are covered either directly under article 2(1) and (2) of the OECD Model, or under article 2(4) of the OECD Model. For all these taxes, article 23B of the OECD Model provides relief. Therefore, all of them are covered under article 23B of the OECD Model.

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27. Eberhardt, *supra* n. 12, at p. 184; Rieck, *supra* n. 23, at p. 589; and Arginelli, *supra* n. 12, at p. 20.
28. Case 8 K 1860/16 (26 Aug. 2020), paras. 36 and 38; Haas, *supra* n. 16, at p. 128; W. Kessler & M.L. Dietrich, *Den Worten sollten Taten folgen: die Umsetzung eines Doppelbesteuerungsabkommens*, 20 IStR 3, p. 110 (2011).
29. *See* RU: FAS [*Федеральный Арбитражный суд*] [Federal Arbitration Court (Moscow District)], 9 July 2014, Decision 05-6681/2014, Case A40-135092/13, *Babkin*. *Also see* V. Matchekhin, N. Soloveva & C. Tokareva, *Russia*, in *The Notion of Tax and the Elimination of International Double Taxation or Double Non-Taxation* p. 694 (IFA Cahiers vol. 101B, Sdu Uitgevers 2016), Books IBFD; Helminen, *supra* n. 21, at pp. 45–46.
30. Becker & Loose, *supra* n. 24, at p. 63.

However, it is striking that article 23B of the OECD Model uses the singular form of "tax"; that is, the residence 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 vice versa "as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State". Therefore, it could be assumed that the treaty only provides relief in respect of one of the various taxes on income covered under article 2 of the OECD Model, and only one of the various taxes on capital covered under article 2 of the OECD Model. Nevertheless, this cannot be brought in line with what had been previously concluded; that is, if article 23B of the OECD Model does not limit the scope of the treaty in respect of article 2 of the OECD Model, all the taxes covered under the latter provision also have to be covered under article 23B of the OECD Model.

Another hypothesis could be that for each tax levied in the source state for which a deduction from the tax in the residence state should be granted, the appropriate tax that best fits this purpose needs to be found. However, again this cannot be brought in line with the conclusions drawn before; that is, tax systems can be very different, and the fact that two countries concluded a tax treaty does not mean that both countries harmonized their tax systems. Therefore, looking for taxes in the two countries that fit with each other, under whatever criteria this is decided, could mean that some taxes, namely those that do not fit any other tax in the other country, would be left out. This would imply that taxpayers would not have tax treaty protection under article 23B of the OECD Model for taxes that are, in principle, covered under article 2 of the OECD Model. Again, this would mean that article 23B of the OECD Model might limit the scope of a tax treaty. There is no indication that such a result would be derived from article 23B of the OECD Model.

If, therefore, article 23B of the OECD Model uses the singular form of tax both in subparagraphs (a) and (b), this means that all taxes on income in the source state, as well as in the residence state, have to be understood as one "tax" on income. The same is true, vice versa, for all taxes on capital; they have to be understood as one "tax" on capital.

Each tax listed in article 2(3) of the OECD Model, therefore, has to be categorized either as part of the "tax on income" or as part of the "tax on capital". This is not only true for those taxes that would already fall under the definition of "taxes on income an on capital" in article 2(1) and (2), but also for those taxes for which the scope of the treaty is extended by listing them in article 2(3) of the OECD Model, although, they do not fall under this definition. The same effects might occur under article 2(4) of the OECD Model if taxes are covered under this provision because they are identical or substantially similar to taxes listed in article 2(3) but do not meet the requirements under article 2(1) and (2). At first sight, it appears odd that taxes have to be treated either as taxes on income or as taxes on capital, although they do not fall under the definition of article 2(1) and (2) of the OECD Model. However, such an effect not only occurs in the context of article 23B of the OECD Model but also in the context of the allocation rules of the OECD Model; that is, each tax that is covered under one of the paragraphs of article 2 has to be allocated to one of the provisions of articles 6 to 21 or to article 22 of the OECD Model, even if such a tax is not a tax on income and capital for the purposes of article 2(1) and (2).

7.3.2. How to distinguish between "taxes on income" and "taxes on capital"

There is a distinction between "taxes on income" and "taxes on capital" for the purpose of the application of the distributive rules (articles 6 to 22 of the OECD Model), and the credit method (article 23B of the OECD Model). However, drawing this distinction might be challenging in some scenarios in which the nature of the tax might not be apparent at first glance. For example, in the case of the Netherlands, up to 2016, income from savings and investments of natural persons was deemed to produce a notional yield of 4% taxed at a flat rate of 30%, which equalled to 1.2% on capital or on "the annual average value of the net assets".[31] In substance, this was a "net wealth tax" and should therefore be covered under article 22 and treated as a "tax on capital" for the purpose of article 23B.

Similarly, another example that illustrates this difficulty are minimum income taxes.[32] These taxes are imposed on taxpayers even if they do not perceive profits in the taxable year, but if the income obtained exceeds a certain amount, then it is taxed under regular income tax. There are different ways for their computation: on the value of the assets,[33] as a lump-sum payment[34] or on the gross income.[35] In the first scenario, it is questionable whether the tax can be considered a "tax on income" rather than "tax

31. Since 2017, this income is taxed at the same flat rate of 30% on a weighted notional yield that is significantly lower than 4% and is more in line with the actual yields of the assets. *See* M. Veldhuijzen, *Netherlands – Individual Taxation* sec. 1.5., Country Surveys IBFD (accessed 30 Nov. 2021).
32. M. Lang, "*Taxes Covered" – What Is a "Tax" According to Article 2 of the OECD Model?*, 59 Bull. Intl. Taxn. 6, p. 219 (2005), Journal Articles & Opinion Pieces IBFD.
33. In this scenario, the tax is based on the value of the assets, as was the case in Luxembourg before 2016; *see* R. Offermanns, *Luxembourg – Corporate Taxation* sec. 1.6.3., Country Surveys IBFD (accessed 30 Nov. 2021). In addition, this was the case in Colombia and its presumptive income tax system up to the taxable year of 2020 (arts. 188-189 Colombian Tax Code). The Colombian system determined as presumptive income a percentage (0.5% for 2020) of the net worth of the taxable person in the preceding tax year, which in the event of being higher than the net income was used to calculate their income tax liability.
34. This is the case in Austria, which determines an annual minimum tax of EUR 3,500 for public companies and EUR 1,750 for limited liability companies; *see* Y. Schuchter & A. Kras, *Austria – Corporate Taxation* sec. 1.10.1., Country Surveys IBFD (accessed 30 Nov. 2021).
35. This is the case of the Philippines and its minimum corporate income tax that applies when the standard CIT is lower than 2% on the company's gross income, *see* J. Ocampo & K. Ocampo, *Philippines – Corporate Taxation* sec. 1.10.1., Country Surveys IBFD (accessed 30 Nov. 2021).

on capital" because the tax liability is determined by reference to the value of the capital owned by the taxpayer and not the profit obtained out of it. In the second case, the tax does not fit under the notion of "tax on income" or "tax on capital"[36] because it is not calculated in relation to either the profit or the value of the assets. However, if the whole tax is covered under the treaty, including the minimum income tax, the tax still has to be allocated to one of the two categories for the purpose of article 23B of the OECD Model, even if it seems to be extremely difficult to make the decision. Finally, if the tax is based on the gross revenue, it could be argued that the tax may be based on income in a broad sense, as a prior stage to the determination of the profit. On top of these complexities, the distinction becomes more difficult to draw because, usually, the jurisdictions adopting these taxes permit a credit carry-forward for these minimum taxes against the regular income tax levied in subsequent years.

Capital appreciation presents another case in which the distinction between "taxes on income" and "taxes on capital" is hard to draw. Article 2(2) of the OECD Model provides that "taxes on income" and "taxes on capital" encompass taxes imposed on the total income, on the total capital, or on the elements of income or of the capital, including taxes on capital appreciation. The wording of this provision and its joint definition of "taxes on income and on capital" leaves it unclear as to what the nature of a "tax on capital appreciation" should be.[37] In any case, it is without dispute that taxes on capital appreciation are covered by the treaty, regardless of the nature of the tax imposed on these unrealized gains.[38] Furthermore, from the Commentary on Article 13 of the OECD Model,[39] and its reference to the application of articles 6, 7, 13 or 21, all distributive rules applicable to income, it is clear that these kinds of taxes should be considered as "taxes on income".[40]

Other types of taxes, when determining their nature, can be particularly challenging, such as taxes on wages and salaries, or payroll taxes. According to article 2(2) of the OECD Model, these taxes are covered by the treaty; however, neither this article nor its Commentary determines whether these are "taxes on income" or "taxes on capital".[41] In Austria, the municipal tax (*Kommunalsteuer)* is designed as a payroll tax.[42] When applying the distributive rule to this tax, some authors have determined that although not expressly addressed, it should fall under the scope of article 7 or 21 of the OECD Model, treating it as a "tax on income".[43] Nevertheless, even if payroll taxes are treated as "taxes on income" for the purpose of the treaty and fall under the scope of one of the aforementioned articles, they do not have the inherent nature of a "tax on income".[44] In fact, if these taxes were not explicitly mentioned in article 2(2) of the OECD Model, they would probably not be treated as "taxes on income", and thus they would fall outside the scope of the convention.[45]

7.4. The application of the credit method to multiple taxes

7.4.1. The application of the credit method to multiple taxes: Same items of income

The Commentary on Article 23B of the OECD Model leaves the operation of the credit method to the domestic law of the contracting states.[46] However, from the wording of this provision, it is clear that the credit method in article 23B is applied on the basis of the per-country limitation: "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". Therefore, the foreign taxes paid over all items of income that may be taxed in the other contracting states, are creditable against the domestic taxes attributable to the income derived in that state. Thus, article 23B of the OECD Model grants a credit for the tax paid in the source state up to the tax liable in the residence state for the aggregate amount of all the items of income derived in the other state.[47] The following examples serve to illustrate these effects.

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36. Lang, *supra* n. 32, at p. 219.
37. W. Cui, *Article 2: Taxes Covered* sec. 3.4., Global Tax Treaty Commentaries IBFD (accessed 30 Nov. 2021).
38. S. Simontacchi, *Capital Gains (Article 13 OECD Model Convention)*, in *Source versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, p. 151 (M. Lang et al. eds., Kluwer Law International 2008).
39. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 13* para. 9 (2017), Treaties & Models IBFD.
40. M. Lang, *Der Sachliche Anwendungsbereich Der Doppelbesteuerungsabkommen Auf Dem Gebiet Der Steuern Vom Einkommen Und Vom Vermögen*, in *Praxis des Internationalen Steuerrechts: Festschrift für Helmut Loukota zum 65. Geburtstag,* p. 273 (M. Lang & H. Jirousek eds., Linde 2005); Simontacchi, *supra* n. 38, at p. 153.
41. See para. 3 *OECD Commentary on Article 2* (2017), which only reiterates the wording of the provision in Article 2(2) MC and makes reference to these taxes in Germany (*Lohnsummensteuer*) and France (*taxe sur les salaires*) without determining their nature.
42. The Austrian Supreme Administrative Court when assessing the comparability of this tax with its antecessor the trade tax (*Gewerbesteuer*) and its payroll tax base (*Lohnsumme*) has confirmed this position. *See* AT: VwGH [*Verwaltungsgerichtshof*] [Supreme Administrative Court], 15 Dec. 1999, Case 98/13/021; 3 Aug. 2000, Case 99/15/0265; 28 Mar. 2001, Case 2000/15/0036. Also, *see S. Haas, Die Kommunalsteuer im Anwendungsbereich des DBA*, 618 ÖStZ 17, p. 470 (2020).
43. M. Züger, *Kommunalsteuer, sonstige Lohnabgaben und Doppelbesteuerungsabkommen*, 10 SWI 4, p. 167 (2000); Haas, *supra* n. 42, at p. 472.; F. Wassermeyer, *Art. 2,* in *DBA*, m.no. 41 (F. Wassermeyer et al. eds., 85th edn., C.H. Beck 2021).
44. Cui, *supra* n. 37, at secs. 3.5. and 5.1.1.; Helminen *supra* n. 21, at p. 35; K. van Raad, *The Concept of Tax in the OECD Model*, in Peeters et al. eds., *supra* n. 2, at p. 261.
45. Cui, *supra* n. 37, at sec. 3.5.
46. Paras. 60-62 *OECD Model: Commentary on Article 23B* (2017).
47. M. Lang, *Introduction to the Law of Double Taxation Conventions* sec. 10.3.3. (3rd edn., Linde 2021).

Starting with a very simple case study: Company A is a resident of State R and has a permanent establishment (PE) in State S. In the fiscal year, Company A receives a business income of 100 through its PE. In State S, the corporate tax rate is 20%, whereas State R levies a corporate tax of 25%. The treaty between States R and S adopts the credit method, according to article 23B of the OECD Model.

The result is clear: State S levies a tax of 20, State R of 25, and State R grants a credit of 20. Therefore, the final tax burden, in State R, is 5.

Modifying the fact pattern slightly: Company A is a resident of State R and has a PE in State S. In the fiscal year, Company A receives a business income of 100 through its PE. In State S, a federal corporate tax and a municipal corporate tax is levied, each with a tax rate of 10%, whereas State R levies a corporate tax of 25%. The treaty between States R and S adopts the credit method to provide relief from double taxation, in accordance with article 23B of the OECD Model, and both federal and municipal taxes are covered under that treaty.

The two taxes in the source state have to be treated as one single tax for treaty purposes. The result therefore remains the same: State S levies in total taxes of 20, State R of 25, and State R grants a credit, for both source taxes, of 20. The final tax burden in State R, therefore, is 5.

Modifying the facts one more time: Company A is a resident of State R and has a PE in State S. In the fiscal year, Company A receives a business income of 100 through its PE. In State S, a corporate tax is levied at a tax rate of 20%, whereas State R levies a federal corporate tax of 15% and a municipal corporate tax of 10%. The treaty between States R and S adopts the credit method to provide relief from double taxation, in accordance with article 23B of the OECD Model, and both federal and municipal taxes are covered under that treaty.

Again, if both taxes in the residence state for tax treaty purposes are treated as one single tax, the result should remain the same; that is, whenever there is more than one “tax on income” or “tax on capital”, the various taxes have to be treated as if they were one tax. This is also the case if the two or more taxes are levied in the residence state. Therefore, the application of the credit method should have the same effect as in those cases in which there is only one tax levied in the residence state. For that reason, the logical consequence of considering that the tax liability or the amount of tax paid in each of the contracting states, as an aggregate or just one tax, is the application of the credit on a pro rata basis, taking into account each of the various taxes levied in the residence state. Unlike the prioritization of the taxes or the selection by the taxpayer of the most favourable option, the proportional assessment of foreign taxes against more than one tax at residence is the theory that provides the most sound basis for the direct application of article 23B of the OECD Model.

Following this alternative, the credit is granted on a pro rata basis. This means that the foreign tax is deducted against the various taxes liable in the residence state, in accordance with the share of these taxes, in the entirety of the domestic tax attributable to the income, which may be taxed in the other state; that is, in accordance with its maximum creditable amount. Therefore, the maximum credit of each tax must be determined, and their sum will constitute the maximum credit for the foreign taxes. However, because the pro rata application does not draw any distinction between the different taxes on income liable in the residence state, it confirms more clearly that these taxes are of the same kind for the purpose of the treaty, and they should be treated accordingly.[48]

In terms of numbers, this has the following consequences: From the federal corporate income tax of 15, a foreign tax of 12 has to be deducted, and from the municipal corporate income tax of 10, a foreign tax of 8 has to be deducted. This means that the overall tax burden in the residence state is still the same: 3 (federal corporate income tax) + 2 (municipal corporate income tax) = 5.

The pro rata approach, as explained in this section, is the result derived from the direct application of article 23B of the OECD Model. However, since under the OECD Model all taxes are treated as one single tax, it is only the result that matters; that is, if the domestic legislator introduces a rule that gives, for credit purposes, priority to one of the taxes levied in the residence state, this is perfectly in line with the treaty obligations. If the domestic legislator, for example, decides to give priority to federal corporate income taxes, this complies with the tax treaty; therefore, in the case study described here, the foreign corporate tax can be credited – first against the totality of the federal corporate income tax, and then the remaining taxes of 5 can be deducted from the municipal corporate income tax. The final municipal corporate income tax burden then is 5, equal to the final overall tax burden in the residence state.

7.4.2. The application of the credit method to multiple taxes: Different items of income

A slightly diverse situation arises when different items of income are concerned. Again, a case study serves to illustrate the issue: Company A is a resident of State R and has a PE and immovable property in State S. In the fiscal year, Company A receives a business income of 100 through its PE, and capital gains of 100 due to the sale of its immovable property. In State S, the tax rate for both types of income is 10%, whereas in State R the tax rate for business income is 5% and for capital gains 20%. Thus, the

48. Kessler & Dietrich, *supra* n. 28, at p. 110.

tax burden in the residence state equals 25 (5 for the business income and 20 for capital gains), whereas the foreign tax paid in State S amounts to 20 (10 for the business income and 10 for capital gains). The treaty between States R and S adopts the credit method for the relief of double taxation along the lines of article 23B of the OECD Model.

In this case, foreign taxes of 20 can be credited against a tax of 25 in State R. Because the only limitation stemming from the double taxation relief article is the "per-country limitation",[49] the different items of income and foreign taxes imposed on them are aggregated and credited up to the amount of tax due in the residence state.[50] The tax paid in State S, on those items of income, equals 20, which can be entirely credited, hence only 5 of tax would have to be paid in State R.

Changing the assumptions slightly: Company A is a resident of State R and has a PE and immovable property in State S. In the fiscal year, Company A receives a business income of 100 through its PE and capital gains of 100 due to the alienation of the immovable property located in State S. In State S, business income is taxed under a corporate income tax rate of 20 %, and capital gains are taxed under capital gains tax (CGT) of 30 %. In State R, both the business income and capital gains are taxed under the corporate income tax at a rate of 25%. The treaty between States R and S adopts the credit method, according to article 23B of the OECD Model.

Under article 23B of the OECD Model, the maximum tax credit is calculated using the per-country method.[51] Therefore, the total tax burden in the residence state is 50 (25% of 200). The source state levies a tax of 20 (business income) and of 30 (capital gains). Under the per-country limitation, which follows from article 23B of the OECD Model, the residence state has to deduct the total amount of taxes levied in the source state from its taxes, which means that no taxes have to be paid in the residence state. Under a per-item approach, the result would be different: Only 25 of the tax on the capital gains could have been credited. Source taxes of 5 would have been "lost".

Changing the fact pattern for the last time: Company A is a resident of State R and has a PE and immovable property in State S. In the fiscal year, Company A receives a business income of 100 through its PE and capital gains of 100 due to the alienation of the immovable property. In State S, the corporate income tax rate for both types of income is 10%. In State R, the business income is taxed under the CIT at a rate of 5%, and capital gains are taxed under a separate capital gains tax at a tax rate of 20%. The treaty between States R and S adopts the credit method, according to article 23B of the OECD Model.

Looking at each tax levied, in the residence state separately, State R would have to deduct the foreign tax from its corporate income tax, which means that no corporate income tax is levied, and there is an amount of 5 that cannot be credited. As far as the capital gains tax is concerned, after the credit, the capital gains tax is reduced to 10. However, the remaining amount of 5, stemming from the foreign corporate income tax, cannot be deducted from the capital gains tax.

The result is different if, as suggested here, the two taxes in the residence state are treated as one single tax for tax treaty purposes: Under article 23B of the OECD Model, the maximum tax credit is then calculated using the per-country method. The total tax burden in the residence state is therefore 25 (5% of 100 and 20% of 100). The source state levies a tax of 20 (10% of 200). Under the per-country limitation, which follows from article 23B of the OECD Model, the residence state has to deduct the total amount of taxes levied in the source state from its taxes, which means that taxes of 5 have to be paid in the residence state. Again, a proportionate allocation of the taxes levied in the source state against the taxes levied in the residence state would mean that a tax of 1 would remain as corporate income tax, and a tax of 4 would remain as capital gains tax. However, the domestic legislator is free to decide otherwise, as long as the tax in the residence state is not higher than 5. A strong argument for this interpretation of article 23B of the OECD Model is that it should not make a difference for tax treaty purposes whether the residence state levies one single corporate income tax, covering both business income and capital gains, or whether the residence state levies a separate business income tax and a separate capital gains tax. Otherwise, mere differences in the legal technique would influence the final result.

7.5. Conclusion

There is a twofold problem when analysing the credit method in cases where there is more than one tax in the residence state. The first question seeks to determine whether article 23B of the OECD Model limits the granting of the credit to only "one" tax in each of the contracting states. As explained here, this is not the case, as article 23B of the OECD Model does not impose an additional limit to the scope of the treaty and, therefore, all the taxes covered in article 2 of the OECD Model must be taken into account for applying the credit method, just as if they were one single tax. This position is, in principle, also supported by the various court decisions discussed in this chapter. It is only controversial whether a credit might be denied because of the absence of specific implementation measures in the residence state. However, the treaty provisions leave it to the domestic law to provide detailed rules to implement the credit method but not to decide whether they wish to apply the credit method. The second issue aims to

49. *See*, with further references, ch. 6.
50. R. Ismer, *Artikel 23B*, in *DBA* m.no. 145 (K. Vogel & M. Lehner eds., 7th edn., CH Beck Online 2021).
51. *See* ch. 6.

determine how the credit method should operate when there is more than one tax in the residence state. According to the position adopted in this chapter, in these situations, the foreign tax should be credited against the various taxes levied in the residence state in proportion to their share in the total sum of the maximum tax credit. Thus, the creditability of foreign taxes is not dependent on their similarity with the domestic taxes because that would imply the prioritization of certain taxes before others, which is not a requirement set forth in article 23B of the OECD Model.

Nevertheless, neither article 23B of the OECD Model nor its Commentary provides detailed criteria for those cases in which there is more than one tax in one of the two states. In any event, for tax treaty purposes, all “taxes on income” should be considered as one tax, and all “taxes on capital” should be considered as one tax. The result of the application of the credit method should not be different, whether the residence state levies just one “tax on income” or just one “tax on capital”, or levies two or more such taxes on income or on capital.