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What Is a "Tax Paid in That Other State" under Article 23 of the OECD Model?

Professor Michael Lang provides us, in this 75th anniversary issue of the *Bulletin for International Taxation*, his view on the meaning and implications of the phrase "tax paid in that other state" in article 23 of the OECD Model.

1. The Tax Credit under Article 23A(2) and 23B of the OECD Model[1]

Tax treaties that provide for the application of the credit method establish a linkage between the tax law provisions of the two contracting states. The tax calculated on the basis of the law of the state of source is deducted from the tax calculated according to the law of the state of residence. Accordingly, the tax amount ultimately payable in the state of residence depends on the tax amount that was paid in the state of source.

This interaction between the two tax jurisdictions gives rise to numerous interpretation issues. For instance, the question arises as to when a tax levied by the state of source is considered "paid" in the state of residence for the purposes of the application of article 23A(2) and 23B of the OECD Model. According to some views, the fact that a tax liability arose will suffice.[2] In some states, the tax administrations require that the tax has at least already been levied, for example, by a withholding tax agent, or even that the tax amount has already been received by the tax administration.[3] The opinion according to which the tax assessment in the state of source must already be final is also controversial.[4] On the one hand, there is a debate over whether the prepayments made in the case of periodic taxes common in several states already qualify for crediting.[5] On the other hand, different practices exist on how to proceed when the taxpayer takes legal action against the tax assessment, and, therefore, one cannot rule out that, once the legal dispute is resolved, the tax burden in the state of source may be lower than initially assumed by the tax administration.[6]

Where the initial assessment of the tax levied in the state of source already qualifies for crediting, the question arises as to what should be done when successful legal action by the taxpayer later results in a reduction of the tax amount to be paid. The same applies when, for example, the tax to be paid in the state of source increases as a result of a later tax audit. It is often held that corrections of the taxes already paid in the state of residence may sometimes no longer be possible, due to the time limits resulting from the procedural provisions of the state of residence.[7] Anyone who wants to ensure that the obligation under a tax treaty to credit the foreign tax, as provided for in article 23A(2) or article 23B of the OECD Model, must take the line that those articles are also of procedural significance and, at least in those cases in which the tax in the state of source increases, they should take precedence over the provisions of domestic procedural law.[8]

In the present article, however, I wish to address a different question that results from the interaction between the two tax law systems relating to the credit method, one which finds little attention in the relevant literature.[9] This question is whose role is it to establish whether the tax levied in the state of source also corresponds to the tax law provisions of the state of source? Is this the task of the authorities of the state of residence, or are the authorities of the state of residence bound by the assessment of the authorities of the state of source? (*See* section 2.)

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1. Most recently, the *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.
2. On this view and its critique, *see* A. Rust, *Art. 23A/23B – Methods for the Elimination of Double Taxation*, in *Klaus Vogel on Double Taxation Conventions* 5th edn., para. 61 (E. Reimer & A. Rust eds. Kluwer L. Intl.), forthcoming.
3. Comprehensively, *see* F. Fiala, *The Methods to Avoid Double Taxation and Their Implementation in Domestic Law*, in *Tax Treaties and Procedural Law* sec. 6.3.1. (M. Lang et al. eds., IBFD 2020), Books IBFD.
4. *See*, for example, Rust, *supra* n. 2, at para. 44.
5. For these issues in detail, *see* G.W. Kofler & F.P.G. Pötgens *Article 23 – Methods for Elimination of Double Taxation – Global Tax Treaty Commentaries* sec. 3.2.2.2., Global Topics IBFD.
6. *See* G. Blanluet & P.J. Durand, *General Report*, in *Key practical issues to eliminate double taxation of business income*, sec. 2.5.2.1. (IFA Cahiers vol. 96B, Sdu Uitgevers 2011), Books IBFD.
7. *See* I. Benshalom, *Israel: The Relationship between Domestic Law and the Tax Treaty in the Interpretation of the Relief from Double Taxation Article*, in *Tax Treaty Case Law around the Globe 2017* sec. 3 (M. Lang et al. eds., Linde and IBFD 2018), Books IBFD; Fiala, *supra* n. 3, at sec. 3.1.
8. *See* M. Lang, *The Procedural Conditions for the Implementation of Tax Treaty Obligations under Domestic Law*, 35 Intertax 3, sec. 4. (2007) and Fiala, *supra* n. 3, at sec. 6.3.2.
9. Only touching the issue, *see* Kofler & Pötgens, *supra* n. 5, at sec. 3.2.2.2.

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2. Assessment by the Authorities of the State of Source or Those of the State of Residence?

Prima facie, this question may appear to be strange. Where the tax of the state of source is concerned, it seems obvious that the assessment by the authorities of the state of source should be relevant. After all, they are responsible for levying the tax. The civil servants who work in the tax authorities of the state of source are experts in the field of tax law of that state. On the other hand, the tax authorities of the state of residence are rarely familiar with the tax laws of the state of source.

One must keep in mind, nonetheless, that, in many states, it is not always the tax authorities of the state of source who are responsible for the application of its tax law provisions. This position is usually the case, for example, when it comes to the levying of withholding taxes. In these constellations, the legislature outsources the levying of taxes – and, therefore, the application of the tax laws – to third parties, for example, to the bank paying the interest, to the company paying the dividend or to the employer paying the salary. Taxpayers often have to calculate and pay the due tax amount themselves, and must not wait until the tax authorities order them the tax to pay. In such cases, taxpayers apply the tax laws and ultimately also interpret them themselves. The tax authorities verify this assessment only at a later stage, in the course of tax audits. In many states, however, such tax audits are only carried out randomly, so that the application of the tax provisions by the taxpayers is often effectively final. Anyone who automatically assumes that the tax authorities of the state of residence are bound to the interpretation of the state of source's tax law provisions carried out in the same will be shaken by doubts the moment they realize that this interpretation was left to the taxpayers themselves.

Given the wording of article 23B of the OECD Model,[10] this provision mandates that:

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

The amount to be deducted must clearly be income or capital "tax paid in that other State". The provision does not explicitly dictate, however, who must determine whether the payment made in the other state is a "tax". As, however, article 23B of the OECD Model is addressed to the state of residence and must be applied by the latter's tax authorities, the question as to whether the amount to be deducted is a "tax" paid in the state of source must be answered by the tax authorities of the state of residence. Where, for example, an amount corresponding to 40% of the profits of a permanent establishment (PE) is retained in the state of source, and is paid directly to or is prescribed directly by the tax authorities, despite the fact that the tax pertaining to such profits only amounts to 30%, the tax authorities of the state of residence must not assess the difference of 10% of the profits as "tax", and, therefore, must not deduct it from its own tax.

The explanations made to the Commentary on Article 23 of the OECD Model (2000)[11] may be used as an argument against the above view:

> 32(1) Both Articles 23 A and 23 B require that relief be granted, through the exemption or credit method, as the case may be, where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention. Thus, the State of residence has the obligation to apply the exemption or credit method in relation to an item of income or capital where the Convention authorises taxation of that item by the State of source.
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> 32(2) The interpretation of the phrase 'may be taxed in the other Contracting State in accordance with the provisions of this Convention', which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.
>
> 32(3) Different situations need to be considered in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

These explanations seem to assume that, in those cases in which the interpretation of the convention is based on the law of the state of source, it is also the latter that carries out the assessment. On this premise, one could be tempted to believe that, when the question is whether, and to what extent, a "tax" of the state of source is involved, and, therefore, that the tax law of the state of source must apply, it is *a fortiori* for the tax authorities or the legal practitioners of that state to take this decision.

One could argue against this, however, to the effect that the explanations given in the Commentary on Article 23 of the OECD Model[12] are not very helpful. This position arises not only because they wrongly claim that domestic law should be used for the interpretation of treaty provisions.[13] On the contrary, I believe the interpretation provision in article 3(2) of the OECD Model convincingly emphasizes that tax treaties must be interpreted primarily in the light of their context.[14] Yet even if one were to put the case for an interpretation of tax treaties accord-

10. For the sake of simplicity only reference to article 23B of the *OECD Model* (2017) is made. The wording of article 23A(2) of the *OECD Model* (2017), however, corresponds to article 23B(1)(a).

11. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23* para. 32(1), (2) and (3) (29 Apr. 2000), Treaties & Models IBFD.
12. Most recently, *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23* (21 Nov. 2017), Treaties & Models IBFD.
13. Further on this argument, *see* M. Lang, *Tax Treaty Interpretation – A Response to John Avery Jones*, 74 Bull. Intl. Taxn. 11, sec. 2.1. (2020), Journal Articles & Opinion Pieces IBFD.
14. Id., at sec. 7.

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ing to domestic law,[15] the quoted formulation of article 23A and 23B of the OECD Model, i.e. "may be taxed in the other Contracting State in accordance with the provisions of this Convention" does not allow for an interpretation according to which the tax authorities of the state of source must decide in a binding manner on behalf of the state of residence whether the state of source is entitled to taxation rights under the tax treaty in question. Instead, what also applies here is that articles 23A and 23B of the OECD Model address the state of residence, and, therefore, must be applied by its tax authorities. Accordingly, it is they who are responsible for this assessment. The position taken in the quoted passages of the OECD Commentary on Article 23, according to which the interpretation of the state of source should prevail, without specifying who the state of source is – the tax authorities, a court or the taxpayers – further relativizes the importance of that part of the OECD Commentary. The fact that this unclear formulation was also incorporated into article 23A(4) of the OECD Model does not make things easier.[16] For all these reasons, which are only touched on here, and were explained in greater detail elsewhere,[17] the quoted passages of the OECD Model and the OECD Commentary on Article 23 are problematic. These passages also do not lend themselves as a justification that the reference to the domestic law of the state of source linked to the term "tax" can be interpreted only as meaning that the prerogative of interpretation lies only with the tax authorities or legal practitioners of that state.

Even if, despite all these misgivings, one was to seize on the said considerations in the Commentary on Article 23 of the OECD Model and were disposed to attach greater importance to the opinions held by those who apply the law in the state of source than those held in the state of residence, one must bear in mind those constellations in which there is often no official review at all in the state of source. This situation can be the case especially when third parties levy withholding taxes, and, therefore, must also determine the tax base and calculate the tax themselves. The same applies when taxpayers declare their income or corporate tax by way of self-assessment, and the tax authorities verify only in exceptional cases through random checks. In these cases, there is nothing to suggest that the tax authorities of the state of residence should completely yield themselves to every interpretation of the state of source's tax provisions by the taxpayer. They must not necessarily accept that their own tax revenue declines because of a higher tax assessment in the state of source. The fact that only a "tax" of the state of source must be deducted from their own taxes entitles the tax authorities of the state of residence to examine the payment made in the other state as to whether it actually constitutes a "tax", or to what extent this amount also contains a voluntary additional payment to the authorities of the state of source, which would then no longer constitute a "tax".[18] The tax authorities of the state of residence can only do so by understanding the application of the tax provisions of the state of source. They can do this by replacing, if necessary, the opinion of the taxpayer or the foreign tax authorities with their own for the purposes of crediting the foreign tax, and, ultimately, by applying itself the provisions of the state of source.

In view of these considerations, one must question once again whether – for example, in the light of the considerations expressed in the Commentary on Article 23 of the OECD Model – greater importance can be attached to the assessment of the taxes payable in the state of source carried out by the tax authorities of the state of source, and, therefore, to the preceding application of the tax provisions of the state of source by its tax authorities. However, the difference to the previously described situation, in which the tax provisions of the state of source are interpreted and applied by the taxpayer alone and without any official verification in the state of source, is often only gradual. The examination of the tax return submitted by the taxpayer is often excursive and, especially in those cases in which the tax authorities of the state of source after a superficial review gains the impression that the taxpayer's calculation of the tax of the state of source was by no means too low, the latter will refrain from, for purely fiscal reasons, going into any in-depth analysis, and will readily approve the taxpayer's assessment. Even if a tax audit should follow, it is unlikely that the tax authorities will voluntarily withdraw its original assessment in case the tax previously calculated was too high, and take any proactive steps to refund the taxpayer for taxes paid in excess. The taxpayer will not be highly motivated to challenge an excessive assessment in the state of source when the taxpayer can expect to be able to deduct the tax paid in the state of source from the tax payable in the state of residence, so that this total tax burden ultimately remains the same.

Vice versa, the possibilities of the tax authorities of the state of residence to follow the application of the tax provisions of the state of source in every detail are slim. Effectively, the tax authorities of the state of residence will not be in a position to fully replace the interpretation of the tax provisions by the tax authorities of the state of source or the taxpayer with its own interpretation of the tax provi-

15. J.F. Avery Jones, *A Fresh Look at Article 3(2) of the OECD Model*, 74 Bull. Intl. Taxn. 11, sec. 1 et seq. (2020), Journal Articles & Opinion Pieces IBFD.
16. *See*, for example, V. Hellebrandt, *Conflicts of Qualification under Article 23A Par. 4 OECD-MC*, in *Exemption Method and Credit Method – The Application of Art 23 OECD Model Convention* (M. Lang et al. eds., IBFD), forthcoming.
17. M. Lang, *Die Bedeutung des originär innerstaatlichen Rechts für die Auslegung von Doppelbesteuerungsabkommen (Art. 3 Abs. 2 OECD-MA)*, in *Außensteuerrecht, Doppelbesteuerungsabkommen und EU-Recht im Spannungsverhältnis: Festschrift für Helmut Debatin zum 70. Geburtstag* pp. 295-304 (G. Burmester & D. Endres eds., C.H. Beck'sche Verlagsbuchhandlung 1997); *The Application of the OECD Model Tax Convention to Partnerships – A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* pp. 20-30; 40-42; 54-56; 78-81 (Kluwer & Linde, 2000); *Die Bedeutung von Verständigungsvereinbarungen nach Art. 3 Abs 2 OECD-Musterabkommen 2017*, in *Territorialität und Personalität: Festschrift für Moris Lehner zum 70. Geburtstag* pp. 209-225 (R. Ismer et al. eds., Ottoschmidt 2019); *General Report*, in *Double non-taxation*, sec. 3.4.2. (IFA Cahiers vol. 89A, Sdu Fiscale & Financiële Uitgevers 2004), Books IBFD; and *Qualification Conflicts – Global Tax Treaty Commentaries* sec. 2.3., Global Topics IBFD.
18. Kofler & Pötgens, *supra* n. 5, at sec. 3.2.2.2.

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sions of the state of source. It will lack detailed knowledge of the administrative practices in the state of source, of the case law on the respective provisions and of the opinions held in the relevant literature. With regard to more than one state, a different language spoken in the state of source will represent an almost insurmountable obstacle for the tax authorities of the state of residence, preventing an in-depth analysis of the legal situation in the state of source.

Accordingly, for purely practical reasons, an analysis by the tax authorities of the state of residence will be limited usually to a superficial audit or a plausibility check. Where an incorrect tax assessment in the state of source is evident, the tax authorities will use, for the purposes of crediting the foreign tax, their own assessment of the foreign tax law to replace that of the taxpayer or of the tax authorities of the state of source. This situation can be the case in the aforementioned extreme example, in which the tax rate in the state of source is 30% and the taxpayer pays the tax authorities of the state of source an amount corresponding to 40% of the tax base, or the tax authorities of the state of source levies such an amount. In such circumstances, it is evident insofar there is no "tax" within the meaning of article 23B of the OECD Model. A similar situation will emerge when high amounts are involved and a possible misapplication of the tax laws of the state of source is of particular gravity. When the tax authorities of the state of residence suspect that the tax of the state of source to be credited was calculated too generously in the state of source, they will probably admonish the taxpayer as part of his cooperation obligation under the tax treaty to provide the corresponding expertise,[19] or even commission an expert opinion, so as to understand the interpretation and application of the domestic tax laws by the taxpayer or the tax authorities of the state of source. The tax authorities will ultimately recognize only that amount of foreign tax for the purposes of crediting as provided in the tax treaty, which lies within the bandwidth confirmed by the expert opinion and within which the tax levied in the state of source should be so if one considers the room for interpretation in the application of the law of the state of source.[20]

3. Obligation to Exhaust All Tax Benefits in the State of Source?

Some tax administrations even go a step further. They demand that the taxpayer has exhausted all benefits in the state of source. For instance, the Austrian tax administration is willing to deduct a Swiss tax under the Austria-Switzerland Income and Capital Tax Treaty (1974)[21] from the Austrian tax due only to the extent that the taxpayer in Switzerland has also made use of the option to carry out deductions from the tax base for children attending school or vocational training, and also made use of the possibility to deduct his contributions to a pension fund from the Swiss tax base.[22]

The Austrian *Bundesministerium für Finanzen* (Ministry of Finance, BMF or *Finanzministerium*), in principle, has adopted the same view with regard to the Austria-Canada Income and Capital Tax Treaty (2012).[23,24] The taxpayer had the possibility of either calculating the relevant income with a deduction of the expenses made there and subject it to the regular tax rate there, or of choosing the option of a final taxation at 25% of gross receipts. The Austrian tax administration was only willing to credit the tax assessed on the basis of the gross receipts taxed at 25% "if it can be assumed that the costs for an optimal taxation are similar to the tax difference between the two taxation options". So, the Austrian tax authorities, by way of exception, do not demand the exhaustion of all benefits in the foreign state, as this principle should not be applied excessively when no major impact on Austrian fiscal revenue is to be expected.

The opinion according to which all benefits in the state of source must be exhausted, i.e. the taxpayer must try to get taxed as low as possible in the state of source, is questionable: The reference made in article 23B of the OECD Model to the tax law provisions of the state of source by the term "tax" also contains those provisions that grant options to the taxpayer. The tax in the state of source must be established in a manner that complies with the tax law provisions of this state and is not in conflict with these. If the law of the state of source grants the taxpayer the option to choose, for example, between a taxation of his net income at the regular rate or a taxation of his gross receipts at a more favourable rate, any decision by the taxpayer must be accepted. Any of these options is in compliance with the tax law of the state of source and is thus covered by the reference of the word "tax". One cannot derive from the rules of the tax treaty in question any requirement according to which the taxpayer must exercise such options in a manner so that the tax in the state of source is as low as possible, so that the tax remaining for the state of residence is accordingly higher.

A different view could only be taken if, in the case of such tax-related options, one was to regard the amount of the higher tax levied if the option is not exercised not as a tax but as a kind of voluntary payment. This would mean that a completely correctly calculated and paid tax according to the domestic law of the state of source is not considered to be a "tax" under the relevant tax treaty. Such a view, however, would lead to odd results. Let us assume

19. For the limits according to the double taxation conventions in how far the burden of proof may be shifted to the taxpayer, *see* Lang, *supra* n. 8, at sec. 4.
20. For efforts to base the criteria of evidence and gravity also on legal reasoning, *see* Hellebrandt, *supra* n. 16.
21. *Convention between the Swiss Confederation and the Republic of Austria for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (unofficial translation) (30 Jan. 1974) (as amended through 2012), Treaties & Models IBFD.
22. AT: *Bundesministerium für Finanzen* (Ministry of Finance, BMF or *Finanzministerium*), *Zweifelsfragen zum Außensteuerrecht und Internationalen Steuerrecht 2007*, BMF 22. 11. 2007, BMF-010221/1897-IV/4/2007, 1.2.
23. *Convention between Canada and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (9 Dec. 1976) (as amended through 2012), Treaties & Models IBFD.
24. AT: BMF, 8 Aug. 2001, EAS 1893.

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that a domestic tax legislation offers both resident companies and permanent establishments of non-resident companies the option that certain items of income are taxed on a gross basis at a rate of 20%. If the option is not exercised, these items of income are taxed on a net basis at a rate of 25%. The only difference is that resident companies have five years after the end of the tax year to exercise this option, whereas the PEs of non-resident companies only have five months. A non-resident company which, for whatever reason, has missed the deadline, and would benefit from the lower tax rate on the gross basis, cannot successfully exercise the option a year after the end of the tax year. Although this different treatment is caused by procedural rules,[25] according to the Commentary on Article 24 of the OECD Model, "it is the result alone which counts".[26] On the assumption that the term "tax" has the same meaning throughout the OECD Model, however, according to the view described previously, the non-resident company is prevented from arguing that this different treatment constitutes a breach of article 24(3) of the OECD Model. The higher levy the corporation has to pay because it did not exercise the option would not be considered to be a "tax" under the OECD Model. Only the amount which would have to be paid if the option were exercised would be regarded a "tax". Consequently, the "taxation" on the PE is not "less favourably levied".

Some options merely lead to timing differences. If one can opt for accelerated or degressive depreciation of certain assets, one will pay less tax in the next periods but more tax in later periods, compared to the situation of not having exercised the option. If one requires options for lower taxation to be exercised, the next question would then be in which tax period the tax should be lower. It is obvious that there is no satisfactory answer.

It must be admitted that the view presented here allows states of source to manipulate the rules. Some low-tax regimes try to protect their companies from controlled foreign company (CFC) legislation in the state of the parent company by offering optional higher tax rates.[27] Similar effects might arise in the context of the credit method. The US Internal Revenue Service (IRS), therefore, particularly deals with soak-up taxes and does not grant a foreign tax credit in such cases, i.e.:

> An amount remitted to a foreign country is not an amount of foreign income tax paid to the extent that liability for the foreign income tax is dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign income tax is dependent on the availability of a credit for the foreign income tax against income tax liability to another country only if and to the extent that the foreign income tax would not be imposed on the taxpayer but for the availability of such a credit.[28]

However, one can be sceptical as to whether the consequences of a certain interpretation of the rules for extreme situations should influence the general interpretation of those rules. If a contracting state has the impression that the other contracting state is changing its domestic rules in order to achieve beneficial results under the tax treaty, which are not acceptable policywise for the first mentioned contracting state, that state can always ask to renegotiate the tax treaty, threaten to terminate the tax treaty or even terminate the tax treaty. As long as the rules remain unchanged, however, such rules have to be applied and its consequences accepted.

Yet, it is clear that, if one accepts that taxpayers may exercise options according to the domestic tax law of the state of source, and whatever the outcome, it constitutes a "tax" under a tax treaty, and difficult delimitation issues cannot be completely avoided. This circumstance can be demonstrated in the preceding example in which the taxpayer is not obliged under Swiss tax law to claim deductions for children in vocational training or to declare contributions to pension funds for tax deduction purposes. According to many tax law systems, nor will the taxpayer be obliged to declare all business expenses incurred and to deduct these from the tax base. Under numerous tax law systems, a taxpayer who waives the right to reduce the tax assessment basis by these expenses will not violate the tax law provisions as a result. If one sees the decision as to whether the taxpayer declares such expenditure incurred also as a right of choice that is covered by the tax law provisions of the state of source, the taxpayer is left with various possibilities of pushing up the assessment basis in the state of source and thus paying more taxes in the state of source, ultimately reducing the tax payable in the state of residence as a result. The taxpayer is not obliged to exercise such options consistently in both states, and, therefore, can use expenses that the taxpayer does not deduct in the state of source to reduce the tax base in the state of residence. As a result, the overall taxation burden remains the same for the taxpayer – as long as the tax paid in the state of source remains covered in the maximum credit amount.

The formulation used by the Tax Court of Canada (TCC) in *Philip A. Meyer* (2004),[29] relating to the Canada-United States Income and Capital Tax Treaty (1980),[30] also reveals this large room for manoeuvre:

> For example, that one might not claim discretionary deductions and voluntarily increase the tax in a foreign jurisdiction would not entitle the CCRA [Canada Customs and Revenue Agency] to deny a credit on that basis. Nor should the CCRA dictate any foreign filing position on a resident taxpayer.[31]

The situation is different, however, when the taxpayer fails to claim a tax reduction under the tax treaty in question in the state of source, because the state of residence is only

25. *See* A. Rust, *Art. 24 – Non-discrimination*, in Reimer & Rust eds., *supra* n. 2, at para. 66.
26. Para. 34 *OECD Model: Commentary on Article 24* (2017).
27. *See* the decision of the German *Bundesfinanzhof* (Federal Fiscal Court, BFH) in DE: BFH, 3 May 2006, I R 124/04.
28. US: I.R.S. Federal Register, vol. 85, Ann. 2020-219, at p. 72134 (12 Nov. 2020).
29. CA: TCC, 4 Mar. 2004, *Philip A. Meyer v. Her Majesty The Queen*, 2004 TCC 199, Case Law IBFD.
30. *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* (26 Sept. 1980) (as amended through 1997), Treaties & Models IBFD.
31. *Philip A. Meyer* (2004), *supra* n. 29, at para. 20.

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obliged to credit a tax levied "in accordance with the provisions of this Convention".[32,33] The view held by the Australian tax administration was as follows:

> The foreign income tax must be correctly imposed under the relevant foreign law and in accordance with any tax treaty the country has with Australia. For example, if country A is limited under a tax treaty to taxing interest derived in that country by an Australian resident at a rate of up to 10%, but country A imposes a domestic tax rate of 25% for interest derived by all foreign residents, only 10% of the tax counts towards the tax offset. The taxpayer would need to seek a refund of the balance (that is, 15%) from country A's tax authority.[34]

The German *Bundesfinanzhof* (Federal Fiscal Court, BFH) has held the same view in a case in which Switzerland levied a 35% withholding tax on dividends.[35] The Germany-Switzerland Income and Capital Tax Treaty (1971), however, provided only for a 15% taxation right in respect of the state of source. The taxpayer was late in submitting his refund application in Switzerland, so that the period provided there for this purpose had already expired. Because the Swiss tax administration refused to refund the withholding tax exceeding the 15%, the taxpayer applied in Germany for the crediting of the entire 35% Swiss withholding tax. The taxpayer was even able to use the wording of the Germany-Switzerland Income and Capital Tax Treaty (1971) as an argument in the taxpayer's favour, as the tax was – initially – levied "in accordance with the convention". The Germany-Switzerland Income and Capital Tax Treaty (1971) allows for the withholding tax to be first levied in full and then to remind the taxpayer to demand a refund for the amount exceeding the rate foreseen in the tax treaty.[36] Because the period provided for this purpose had expired, however, the taxpayer was unable to have the Swiss withholding tax refunded. Nevertheless, the BFH rightly allowed for a crediting of only 15% of the withholding tax. Where the taxation rights between the two states are divided in a manner that the state of source can levy a maximum of 15% of the gross dividend amount in taxes, and the state of residence remains with the tax that results from the difference between those 15% and its own tax rate, one cannot expect the state of residence to credit a higher tax and thus waive its taxation right only because the taxpayer in Switzerland missed a deadline.[37]

The Austrian *Bundesfinanzgericht* (Federal Tax Court, BFG) decided in a similar manner in the case of a taxpayer who, over decades, obtained income from Switzerland that was subject to the full withholding tax there, but was never declared in Austria.[38] When decades later the taxpayer made a voluntary disclosure in Austria and the income was finally subjected to tax there for the previous years, it was too late to demand a reduction of the tax in Switzerland to the extent admissible by the Austria-Switzerland Income and Capital Tax Treaty (1974). Nonetheless, the BFG permitted a crediting only to the extent admissible under the convention.

The same logic was followed in the already mentioned judgment of the TCC in *Philip A. Meyer*.[39] The case involved a US-Canadian dual citizen who was resident in Canada. In his US tax return, however, the taxpayer failed to mention his non-resident-status in the United States and his Canadian residence under the Canada-United States Income and Capital Tax Treaty (1980). Consequently, a pension he obtained in the United States was taxed there at the full income tax rate and not just the reduced 15% tax rate on the basis of the tax treaty in question. The taxpayer applied for a credit of the entire tax levied in the United States. The TCC refused, in the following wording:

> ... where the resident taxpayer has approached his foreign filing position without regard to providing the information necessary to determine the tax payable, such as not submitting required forms or return information to claim a Treaty entitlement, and has refused to correct the error or establish that it was not in error, the resultant overpayment can be regarded as an amount paid other than as a "tax".[40]

Prima facie, the Bulgarian *Върховен административен съд* (Supreme Administrative Court, BSAC) seemed to have decided differently.[41] The BSAC accepted that Italian and Spanish withholding taxes on interest, which, according to the Bulgaria-Italy Income and Capital Tax Treaty (1988)[42] and the Bulgaria-Spain Income and Capital Tax Treaty (1990)[43] should not have been taxed in those countries, still could be deducted from the Bulgarian corporate income tax. However, there is no contradiction to the other judgments mentioned previously in this section. The BSAC saw the legal basis for the credit in its domestic law. It, therefore, held that the provisions on unilateral relief from double taxation had to be applied.[44]

32. *See*, for example, the German BFH on taxes levied in contradiction to *Convention between the German Federal Republic and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (unofficial translation), art. 15 (11 Aug. 1971), Treaties & Models IBFD. *See also* DE: BFH, 1 July 2009, I R 113/08, para. 16, Case Law IBFD. *See* again DE: BFH, 15 Mar. 1995, I R 98/94, Case Law IBFD.
33. An example for such a situation is also when the domestic tax law of the state of source does not comply with one of the non-discrimination clauses (article 24 of the *OECD Model* (2017)) of the relevant tax treaty.
34. AU: Australian Tax Office (ATO), QC 64897, Guide to foreign income tax offset rules 2021, at pp. 3-4 (May 2021).
35. *See* I R 98/94 (1995), *supra* n. 32.
36. *See*, for example, paragraph 19 of the *OECD Model: Commentary on Article 10* (2017). However, the OECD prefers to automatically limit the tax levied at source. *See* paragraph 109 of the *OECD Model: Commentary on Article 1* (2017).
37. In the same vein, *see* the decision of the German *Finanzgericht Münster* (Tax Court of Munster, *FG Münster*) in DE: *FG Münster*, 9 Aug. 1994, 16 K 1215/93 E, EFG 221 (1995).
38. AT: BFG, 12 Mar. 2015, RV/7100040/2013.
39. *Philip A. Meyer* (2004), *supra* n. 29.
40. Id., at para. 20.
41. BG: BSAC, 13 Jan. 2020, Decision 409/2020, Case 7268/2019.
42. *Convention between the People's Republic of Bulgaria and the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital and for the Prevention of Fiscal Evasion* (unofficial translation) (21 Sept. 1988), Treaties & Models IBFD.
43. *Convention between Spain and the People's Republic of Bulgaria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (unofficial translation) (6 Mar. 1990), Treaties & Models IBFD.
44. *See* I. Lazarov, *Bulgaria: Credit of tax levied not in accordance with the Convention [Decision No 409/2020 and of the Supreme Administrative Court]*, in *Tax Treaty Case Law around the Globe 2021* (M. Lang et al. eds., Linde and IBFD), forthcoming.

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4. "Tax Paid in That Other State" under Article 23 of the OECD Model as Subject Matter of Mutual Agreement Procedure or Arbitration Procedure?

Furthermore, one has to examine whether the amount of the "tax paid in that other State", and, therefore, also the interpretation of the tax provisions of the state of source that must be applied for its assessment, can become the subject matter of a mutual agreement procedure (MAP). In this regard, article 25(1) of the OECD Model reads as follows:

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

Accordingly, the decisive question refers to the circumstances under which there could be a "taxation not in accordance with the provision of this Convention". Article 25 of the OECD Model does not require that double taxation exists.[45] The previous considerations have shown that, under article 23B of the OECD Model, the state of residence must credit the tax of the state of source that was actually paid there and was assessed through a correct application of the domestic law of the state of source, and the amount of which also does not exceed the amount that can be levied in the state of source under the relevant tax treaty. When the tax authorities of the state of residence refuse to recognize the entire amount paid in the state of source as "tax paid in that other State" within the meaning of article 23B of the OECD Model, and, therefore, deduct only part of this amount from its own tax, this may lead to a situation where:

> a person considers that the actions of one... of the Contracting State result or will result for him in taxation not in accordance with the provisions of this Convention.

As a result, the taxpayer is entitled to use this as a reason to "present his case to the competent authority of either Contracting State". The procedure to be followed is described in article 25(2) of the OECD Model:

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

Consequently, the question as to whether the tax levied in the state of source exceeds the level admissible under the tax treaty in question can become clearly the subject matter of a MAP. The question can become relevant in practice when, for example, different distributive rules are used by the authorities in the two contracting states involved, which provide for different maximum withholding tax rates. Where the MAP leads to the conclusion that the withholding tax levied exceeded the level admissible under the tax treaty in question, the tax authorities of the state of residence do not need to credit the excessive amount.

Correspondingly, the state of source usually will refund the overpaid tax. One must also bear in mind, however, that the procedural law of the state of source can play a role. The state of source cannot refuse to implement the results of a MAP under article 25(2), last sentence of the OECD Model by invoking time limits in domestic law. Any time limits that were exceeded because of the duration of a MAP by no means preclude the implementation of its results.[46] However, the question as to whether article 25(2), last sentence of the OECD Model also applies when the time limit under domestic law had expired at the time of the implementation of the MAP is an interesting one. If answered in the affirmative, the tax authorities would be able to apply the withholding tax reduction foreseen by the relevant tax treaty by concluding a MAP in those cases in which they would otherwise be unable to do so. Such a position would apply when the tax authorities examine the situation in accordance with article 25(2), first sentence of the OECD Model to establish "if the objection appears to it to be justified". Even if this question is answered in the negative, the subject matter of a MAP can be whether the time limit for a refund foreseen under domestic law is "in accordance with the provisions of this Convention". According to the opinion, in respect of which I provide sufficient arguments elsewhere,[47] this can be the case when the national legislature of the state of source violates the principle of equivalence immanent to treaty law, and grants a refund of taxes in the scope of a tax treaty under more restrictive conditions than in an otherwise purely domestic context. Another barrier in relation to tax treaties may arise from the principle of effectiveness, when refund applications can be submitted in all cases within the same time limit under the law of the state of source, but the time limit for their submission is so short that it makes the assertion of the treaty provisions virtually impossible.[48]

The considerations presented here have demonstrated that the state of residence only needs to credit that part of the amount levied in the state of source that must be levied as tax under the law of the state of source. This circumstance does not imply, however, a binding character of the

45. Para. 13 *OECD Model: Commentary on Art. 25* (2017). In detail, *see* J. Scott Wilkie, *Article 25: Mutual Agreement Procedure – Global Tax Treaty Commentaries* sec. 2.3.1., Global Topics IBFD.

46. *See*, however, the unclear statements in paragraph 39 of the *OECD Model: Commentary on Article 25* (2017), which seems to limit the scope of this provision: "The purpose of the last sentence of paragraph 2 is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits. This provision does not prevent, however, such States as are not, on constitutional or other legal grounds, able to overrule the time limits in the domestic law from inserting in the mutual agreement itself such time limits as are adapted to their internal statute of limitation ...".

47. *See* Lang, *supra* n. 8, at sec. 4.

48. Lang, *supra* n. 8, at sec. 4. Also on this problem, *see* Fiala, *supra* n. 3, at sec. 6.3.2.

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decisions of the tax authorities of the state of source. The determination of the correct amount of tax, and, therefore, the interpretation of the tax provisions of the state of source thus becomes a question of the interpretation and application of treaty law. Accordingly, when the tax authorities of the state of residence refuse to recognize the entire amount paid in the state of source as "tax", and for this reason do not deduct it in its entirety from the tax due in respect of the state of residence, it is possible that the taxpayer "considers that the actions of one... of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention". As a result, the correct application of the tax law of the state of source can become the subject matter of a MAP.

In the state of source, however, the correct application of its own tax provisions is usually not a question of interpretation and application of the relevant tax treaty. When the state of source has under the tax treaty in question the unrestricted right of taxation, it falls exclusively under domestic law to determine the amount of tax to be paid there. When a taxpayer feels excessively taxed there, the taxpayer can only use domestic remedies to appeal. It will not be possible to introduce a MAP on the basis of excessive taxation in the state of source alone, as the taxpayer will not succeed in claiming to be taxed "not in accordance with the provisions of this Convention" in the state of source.[49] This situation, however, has the following consequences. If, in a MAP, the responsible tax authorities agree that only part of the amount paid in the state of source qualifies as "tax" within the meaning of article 23B of the OECD Model and that only this part must be deducted from the tax of the state of residence as a result, this does not mean that the tax authorities of the state of source must refund the excessive amount. The question as to whether taxation was "in accordance with the provisions of this Convention" was posed in the state of residence, but not in the state of source. In essence, a situation may remain in place where an amount is paid to the tax authorities in the state of source, which is not credited as "tax" in the state of residence.

Only in those constellations in which the state of source has a limited taxation right in the form of a percentage of the income under the tax treaty – as in accordance with article 10(2) or article 11(2) of the OECD Model – can the amount of tax become a question of interpretation and application of the tax treaty in the state of source as well. The tax of the state of source is limited to a certain percentage of the gross amount of income. If the amount levied in the state of source – for what reason whatsoever – exceeds the amount provided under article 10(2) or article 11(2) of the OECD Model, the result is "taxation not in accordance with the provisions of this Convention", and must be corrected.

In the aforementioned judgment of *Philip A. Meyer*, the TCC also had to address the question of whether a MAP can be introduced in a case in which the taxpayer did not assert his residence in Canada in the state of source, and the tax authorities of the state of source, therefore, imposed tax on him exceeding the admissible amount under the Canada-United States Income and Capital Tax Treaty (1980). The TCC answered this question in the negative, and held that the taxpayer had "to establish that he filed in the U.S. as required to ensure the benefit of rate limitations under the Treaty".[50]

Article 25 of the OECD Model, however, merely requires that the affected taxpayer "considers that the actions of one... of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention". These conditions are also fulfilled when the tax authorities of the state of source determines the tax, and endorses the view originally held by the taxpayer when preparing his tax return. One can consider that the state of source did not carry out any "action" at all that would justify the conduct of a MAP only when the tax was calculated and paid by the taxpayer without any participation by the tax authorities of the state of source, and the taxpayer then claims, on the implementation of the MAP, that, nevertheless the taxes paid in the state of source exceeded the level admissible under the tax treaty in question. Even in this case, however, the conditions under article 25 of the OECD Model may be satisfied if the taxpayer must expect that an application for refund submitted by him will be rejected. Such an impending or already pronounced rejection may constitute an "action".

The Commentary on Article 25 of the OECD Model probably also adopted this position when it described when the three-year time limit after the "action" begins, and also described the conditions under which one can speak of such an "action":

> In self assessment cases, there will usually be some notification effecting that assessment (such as a notice of a liability or of denial or adjustment of a claim for refund), and generally the time of notification, rather than the time when the taxpayer lodges the self-assessed return, would be a starting point for the three year period to run. Where a taxpayer pays additional tax in connection with the filing of an amended return reflecting a bona fide taxpayer-initiated adjustment (as described in paragraph 14 above), the starting point of the three year time limit would generally be the notice of assessment or liability resulting from the amended return, rather than the time when the additional tax was paid. There may, however, be cases where there is no notice of a liability or the like. In such cases, the relevant time of "notification" would be the time when the taxpayer would, in the normal course of events, be regarded as having been made aware of the taxation that is in fact not in accordance with the Convention. This could, for example, be when information recording the transfer of funds is first made available to a taxpayer, such as in a bank balance or statement. The time begins to run whether or not the taxpayer actually regards the taxation, at that stage, as contrary to the Convention, provided that a reasonably prudent person in the taxpayer's position would have been able to conclude at that stage that the taxation was not in accordance with the Convention. In such cases, notification of the fact of taxation to the taxpayer is enough.[51]

49. However, a taxpayer claiming that one of the applicable domestic tax rules of the state of source does not comply with one of the non-discrimination clauses (*see* article 24 of the *OECD Model* (2017)), can of course initiate a MAP.

50. *Philip A. Meyer* (2004), *supra* n. 29, at para. 24.
51. Para. 23 *OECD Model: Commentary on Article 25* (2017).

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When, on the application for a MAP, the taxpayer takes the position – considered here as incorrect – that the tax paid in excess must be credited in the state of residence, the requirements for the introduction of the MAP are met definitely. The two competent authorities may also reach, in a MAP, the conclusion that the tax paid in the state of source was too high. The two competent authorities are not bound to the claim of a taxpayer who accuses only the state of residence of "taxation not in accordance with the provisions of this Convention".

If a MAP ends without an agreement between the two competent authorities, it is possible to introduce an arbitration procedure under article 25(5) of the OECD Model, i.e.:

> Where,
> a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
> b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities,
> any unresolved issues arising from the case shall be submitted to arbitration if the person so requests in writing....

The introduction of the arbitration procedure, however, requires that the "actions" of one or both contracting states described as unlawful by the taxpayer have – in the meantime –resulted in taxation. Moreover, it should be noted that agreement between the two authorities rules out the introduction of an arbitration procedure.[52] When, in the case of options in the domestic tax law of the state of source, the tax authorities of the contracting states agree that only the amount will be credited in the state of residence which would result if the taxpayer had exploited all the benefits of the state of source, the requirements for the introduction of the arbitration procedure are not met. Accordingly, the Commentary on Article 25 of the OECD Model also rightly states that:

> Where, however, the two competent authorities agree that taxation by both States has been in accordance with the Convention, there are no unresolved issues and the case may be considered to have been resolved, even in the case where there might be double taxation that is not addressed by the provisions of the Convention.[53]

5. Conclusions

The considerations presented in this article have demonstrated that the tax authorities of the state of residence must independently determine whether, and to what extent, the amount paid to the tax authorities of the state of source qualifies as "tax" within the meaning of article 23B of the OECD Model. In doing so, the tax authorities of the state of residence are not bound to the assessment by the taxpayer or the tax authorities of the state of source. The tax authorities of the state of residence must verify whether the tax provisions of the state of source were applied correctly, and must also accept the exercise of options by the taxpayer. Consequently, the question as to whether, and to what extent, the amount paid to the tax authorities of the state of source qualifies as "tax" under article 23B of the OECD Model is a question of interpretation of the tax treaty in question. As a result, it can also become the subject matter of a MAP and subsequently of an arbitration procedure in accordance with article 25(5) of the OECD Model.

52. Explicitly, *see* paragraph 64 of the *OECD Model: Commentary on Article 25* (2017).

53. Para. 71 *OECD Model: Commentary on Article 25* (2017).

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