

Conflicts of Qualification and Double Non-Taxation

I. Change to the OECD Commentary

The Update 2008 of the OECD Model Convention (hereinafter OECD Model) and its Commentary slightly revised, inter alia, Paragraph 32.6 of the Commentary, which deals with double non-taxation arising from conflicts of qualification. The changes of the wording of the Commentaries in this regard are minor; however, since discussions on conflicts of qualification and double non-taxation are highly controversial, these changes deserve a more careful analysis.

Paragraph 32.6 had been added to the OECD Commentary in 2000 and now reads, after having been updated in 2008, as follows: “The phrase ‘in accordance with the provisions of this Convention, may be taxed’ must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.”

In the original 2000 version the phrase “have taxed” was used instead of “have had the right to tax” and the phrase “to tax” instead of “to have the right to tax”. The drafters of the 2008 Update found the phrase “it would otherwise have taxed” to be “unduly restrictive since there are cases where the source State considers that the Convention prevents it from taxing an item of income but that item of income would not have been ‘otherwise taxed’ in that state because

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the item of income is not taxable under the State's domestic law.”¹ According to Russo, the Commentary has been amended to clarify that Article 23 of the OECD Model does not impose on the residence state the obligation to grant relief when the source state considers that the tax treaty prevents it from taxing, regardless of whether or not the source state would tax the income under its domestic law².

II. Policy considerations

This question is part of a bigger discussion. The OECD Commentary has, in its 2000 Update, taken the position that qualification conflicts can be solved under the existing OECD Model by means of interpretation of Article 23 of the OECD Model. The OECD Commentary has followed an approach that had already been taken in the OECD Partnership Report³ and which originally had been developed by Jean-Marc Dery and David Ward⁴ and which had been further elaborated on by John F. Avery Jones et al⁵. According to this position, the phrase “in accordance with the provisions of this Convention” in Article 23 A and B is crucial. The drafters of the 2000 Update of the OECD Commentary argued that this phrase requires the state of residence to grant relief from double taxation in conflicts of qualification resulting from differences in domestic law. The residence state should be bound by the qualification of the state of source in such a case⁶. Since the drafters of the 2000 Update considered qualification conflicts leading to double taxation and qualification conflicts leading to double non-taxation as mirror situations, they dealt with the latter type of qualification conflicts as well. In their view, the phrase “in accordance with the provisions of this Convention” should have relevance for these conflicts, too: The state of residence is not

¹ OECD, *Draft contents of the 2008 update to the Model Tax Convention*, Part I, as referred to by van Raad, *Materials on International and EC Tax Law 2008/2009*, Volume 1, 2008, p. 360.

² Russo, *The 2008 OECD Model: An Overview*, European Taxation 2008, pp. 464 et seq.

³ OECD, *The Application of the OECD Model Convention to Partnerships*, 2009 (paragraphs 102 et seq.).

⁴ Dery and Ward, *Interpretation of double taxation conventions – National Report Canada*, Cahiers de droit fiscal international, Volume LXXVIIIa, 1983, pp. 281 et seq.

⁵ Avery Jones et al, *Credit an Exemption under Tax Treaties in Cases of Differing Income Characterization*, European Taxation 1996, pp. 141 et seq.

⁶ See for a critical discussion of this approach Lang, *The Application of the OECD Model Tax conventions to Partnerships, A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs*, 2000, pp. 40 et seq.

obliged to exempt income which the source state does not tax because that state is prevented from doing so under a tax treaty provision, as it has to be understood under the domestic law of the source state⁷.

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

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

In addition, one should take into account the mirror situation as well: For qualification conflicts where both countries, under their domestic law, feel obliged to apply different tax treaty rules that both confirm their taxation rights, the OECD Commentary has not changed the position taken in its 2000 Update. The Commentary still requires actual double taxation that is caused by the qualification conflict. The mere existence of a qualification conflict is not sufficient. In a situation where the source state does not levy a tax, although it could under its domestically influenced interpretation of the tax treaty, a residence state that is entitled to levy a tax under its understanding of the allocation rules of the treaty is not obliged to exempt

⁷ Paragraphs 32.1 to 32.5 of the OECD Commentary (Update 2000).

the income under Article 23 A of the OECD Model. If the approaches were balanced, a mere qualification conflict making double taxation or double non-taxation possible should be sufficient in both situations or in or neither of them. Either in both cases or in neither case should it be relevant whether tax liability exists under the domestic law of the source state.

III. Legal considerations

It is hard to say whether Article 23 A of the OECD Model provides a sound legal basis for the position taken by the 2008 Update of the OECD Commentary. Even for the approach taken by the 2000 Update it is debatable whether it is covered under Article 23 A. It is doubtful whether the wording of Article 23 A, which was neither changed in 2000 nor later, expresses the meaning intended by the drafters of the 2000 Update⁸. It is often contested that the phrase “taxed ... in accordance with the provisions of the Convention” actually contains a reference to the law of the source state. Instead, that phrase can be understood as meaning that it is up to the tax authorities of the state of residence to judge either independently from the treaty or – as an applying state in accordance with Article 3 (2) of the OECD Model – based on the understanding familiar to its national law, whether the source state has the taxation right in a specific situation. If the position expressed in the 2000 Update is not covered by the wording of Article 23, it cannot be considered relevant at all. However, those authors regarding the 2000 Update as relevant for the interpretation of Article 23 assume that the position taken by the 2000 Update is either covered under the wording of the OECD Model Convention, or that the intention of the drafters is explicit enough to replace the clear wording of the convention. Some of these authors consider the 2000 Update only relevant for the interpretation of those treaties negotiated or concluded since then; others go even so far as to take the 2000 Update into account for the interpretation of older treaties.

Additional difficulties are caused by the fact the 2000 Update considers the qualification of the source state only insofar as relevant as that qualification is influenced by the domestic law. If, however, the qualification conflict has its root in a different interpretation of the facts of the case or in a different interpretation of those treaty terms that have to be interpreted without reference to domestic law, the residence state may not be bound by the qualification of the source state. That distinction seems to have its basis in Article 3 (2) of the OECD

⁸ For a discussion of these arguments see Lang, *Double non-taxation – General Report*, Cahiers de droit fiscal international, Volume 89a, 2004, pp. 95 et seq.

Model. Under that provision, any terms not defined in the treaty must, “unless the context otherwise requires, have the meaning that it has at that time under the law of that state for the purposes of the taxes to which the Convention applies”. The meaning of Article 3 (2) of the OECD Model is heavily disputed. Some authors put a lot of emphasis on the phrase “unless the context otherwise requires” and regard that provision as confirming the obligation to interpret the treaty as much as possible autonomously, without reference to domestic law⁹, whereas others take the opposite position and almost ignore that phrase and therefore feel obliged, as a general rule, to interpret undefined tax treaty terms in accordance with domestic law¹⁰. Other authors, however, take positions in between, e.g. by interpreting the term “require” as taking into account the context only if that is supported by strong arguments¹¹.

A recent discussion between *Heinz Jirousek* and *Andrew Dawson* illustrates the above-mentioned difficulties¹²: They took the case of a CEO of a corporation who is a resident of state A as an example. The corporation has its seat and place of effective management in state B. They assumed that the CEO exercises her activities partly in state A and partly in state B. According to the approach taken by the Austrian tax authorities, the qualification of the CEO’s remuneration under Articles 15 or 16 of the OECD Model depends on domestic law¹³, whereas the UK tax authorities are of the opinion that if the CEO is on the board of directors and some of her responsibilities are in her capacity as a director, while other responsibilities are in her capacity of running the company on a day-to-day basis, the activities have to be split according to that distinction. The UK tax authorities would apply Article 16 of the OECD Model to those activities which are performed in the capacity as a member of the board. Under the UK approach, this would be regarded as a question of treaty interpretation, regardless of the qualification under domestic law. Thus, whereas the Austrian tax authorities would apply Article 23 of the OECD Model to prevent either double taxation or double non-

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

¹⁰ See Avery Jones et al, *The Interpretation of Tax Treaties With Particular Reference to article 3 (2) of the OECD Model*, *British Tax Review* 1984, pp. 107 et seq.

¹¹ For a discussion see Lang, *Double non-taxation*, *Cahiers de droit fiscal international* 89a pp. 97 et seq.

¹² See Simader, *International Tax Law Summer Conference in Rust: Taxation of CEO Income – Case Study*, *Steuer & Wirtschaft International* 2008, pp 531 et seq.

¹³ Simader, *Steuer & Wirtschaft International* 2008, p. 531.

taxation, the UK tax authorities would just consider any interpretation different from their own to be wrong. Article 23 of the OECD Model would, in their view, not be applicable.

However, authors who accept the view that the approach followed by the OECD Update 2000 is supported by the wording of Article 23 of the OECD Model should not have a problem extending this position to situations where the source state does not levy a tax domestically and would feel prevented from doing so under the tax treaty as well. Article 23 (1) of the OECD Model requires that the resident of a Contracting State “may be taxed” in the other Contracting State. A person “may” only be taxed in the source state “in accordance with the provisions of this Convention” if the tax treaty does not prevent that state from doing so. Whether tax would actually be levied in the source state, if the tax treaty provisions had not been applicable, is obviously not relevant. In other cases of qualification conflicts Article 23 A (1) would provide exemption in the residence state, regardless whether the source state has exercised its taxation right under the treaty or not.

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

IV. Conclusion

The approach taken by the OECD Update 2000 had received mixed reactions. It has been argued that this approach lacks a legal basis under Article 23 (1) of the OECD Model, and that it might be regarded by source states as an invitation to extend the taxation rights they have under the treaty, simply by changing either the domestic law as such or merely just its interpretation. Residence states, however, that are not willing to give up their taxation rights

may always argue that they do not have to follow the source state's position if they intend to maintain their taxation rights as a result of an autonomous interpretation of the treaty. They can consider themselves to be required by the "context" of the treaty to do so. As a result, the number of cases of double taxation might even increase. Despite these objections, the OECD Committee on Fiscal Affairs has not reconsidered its approach but, in its 2008 Update, has even extended the scope of that approach in order to be able to prevent double non-taxation in certain other situations. The authority for that approach is weak, since the OECD Update has not broadened its interpretation of Article 23 A (1) of the OECD Model in general, but only for situations where it is in the interest of the tax authorities to generate additional tax revenues.

It must not be overlooked that the approach already taken by the 2000 Update, which has been confirmed and developed further by the OECD 2008 Update, tries to cure a disease caused by other positions of the OECD Commentary: The OECD has neither abolished the reference to domestic law in Article 3 (2) of the OECD Model nor has made it clear that the phrase "unless the context otherwise requires" should be understood as broadly as possible. The fewer the cases that occur where domestic law is used to interpret tax treaty terms, the greater is the probability that both states will try hard to interpret the treaty in its context, and thereby reach an understanding of a treaty term that can be accepted in common. This would be best to avoid both double taxation and double non-taxation. Of course, it may be burdensome to focus not only on definitions but to achieve interpretation results by taking into account the wording and the history of a provision, its context and its object and purpose¹⁴. However, making use of the traditional means of interpretation is common to us lawyers whenever we interpret terms of domestic law, which are quite often undefined as well. It is not convincing to forget all our methodology when it comes to the interpretation of tax treaty provisions.

¹⁴ See Lang and Brugger, *The Role of the OECD Commentary in Tax Treaty Interpretation*, Australian Tax Forum 2008, pp. 95 ff