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The Substantive Scope of Double Tax Treaties - a Study of Article 2 of the OECD Model Conventions

Thesis

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## **“Taxes covered” – The Substantive Scope of Tax Treaties**

Patricia Brandstetter

### **Abstract**

Tax treaty protection only goes as far as the treaty’s substantive scope. Nations worldwide have adopted the text of Art. 2 (“Taxes covered”) of the OECD Model Double Taxation Conventions in concluding bilateral treaties to prevent international double taxation in the area of taxes on income and capital, and taxes on estates, inheritances and gifts.

The wording and structure of Art. 2 give rise to a host of ambiguities, creating uncertainty for taxpayers regarding the taxes that come within treaty scope. A research strategy that draws on historic materials documenting the development of Art. 2 throughout the League of Nations, OEEC and OECD seeks to shed light on a provision that has retained its basic format and wording since the 1920s. Recent case law and academic literature are analysed to gain a clearer picture of the common international concepts expressed in tax treaties that use the formulations proposed in the OECD Model Conventions. The research strategy, conceptual models and proposed results aim to contribute to the understanding of the “taxes covered” and to guide subsequent research and heighten awareness of problems in the interpretation and application of the provision on substantive scope in tax treaties.

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## PART I

### Introduction and Methodological Premises

#### 1. The scope and purpose of this thesis

“Mundane though this Article may appear to be, it is in practice one of the key articles in any double taxation convention.”<sup>1</sup>

Tax treaties aim to provide certainty to taxpayers as to their potential tax liability in foreign countries. To this end, they allocate taxing rights between treaty partners regarding the persons and taxes covered under the treaty. The avoidance of double taxation thus only goes as far as the scope of the applicable tax treaty. Tax treaties are “dual” in nature in that they are agreements under international law but also form part of the internal laws of the contracting nations. Determining the substantive scope of the treaty can be a weighty challenge due to differing tax systems and taxation concepts.

The provision on substantive scope in Art. 2 of the OECD Model Tax Conventions on Income and Capital, and on Estates and Inheritances and on Gifts is a fixture in any tax treaty. Together with the provision on persons covered,<sup>2</sup> Art. 2 is the fundament to a sensitive balance struck by way of negotiations between the contracting parties. The substantive scope of a tax treaty determines its application by governmental authorities, courts and taxpayers. Other facets of the scope of application of a tax treaty are the provisions on its entry into force, termination<sup>3</sup> and its territorial field of application.<sup>4</sup>

Despite its relevance in practical treaty application, academic writings on the substantive scope of tax treaties are rare. Pioneer status can be attributed to the considerations of Franz Philipp Sutter and Michael Lang.<sup>5</sup> The wording of Art. 2 in the OECD Model Conventions has been adopted in tax treaties around the globe. This thesis thus investigates the historical genesis, conceptual underpinnings and practical workings of the “Taxes covered” article in both the OECD Model Convention on Income and Capital, and the OECD Model Convention on Estates and Inheritances and on Gifts.<sup>6</sup> The study takes into account official documents archived at OECD facilities in Florence and Paris. The materials documenting the drafting process of the OECD Model Conventions were in large part originally classified as “restricted” and thus inaccessible to the public for decades. As these documents bear testimony of the conceptual underpinnings of the form and substance of Art. 2, their analysis is an integral part in the quest of this thesis to provide a clearer picture of the “taxes covered” under the OECD Model Conventions and treaties modelled thereon.

The outset of the thesis gives an introduction to the legal methodology forming the basis of all considerations and analyses to come. A basic thread throughout the study is the view that treaty terms

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<sup>1</sup> P. Baker, *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital*, editor’s Commentary on Art. 2, R.2 of March 2002, m.no. 2B.01.

<sup>2</sup> Art. 1 of the OECD Model Conventions (“Persons covered”).

<sup>3</sup> In the OECD Model Tax Convention on Income and on Capital, entry into force and termination are provided for in Arts. 30 and 31, respectively; the OECD Model Tax Convention on Estates, Inheritances and on Gifts contains analogous provisions in Arts. 15 and 16. Throughout the study, except where otherwise indicated, references are to the most recent versions of the aforementioned Model Conventions.

<sup>4</sup> Art. 29 of the Income and Capital MC; Art. 14 of the Estate, Inheritance and Gift MC.

<sup>5</sup> See Sutter, “Der sachliche Anwendungsbereich des ErbSt-Musterabkommens“, in Aigner et al. (eds.) *Erbschaftssteuern und Doppelbesteuerungsabkommen* (2002), pp. 41 et seq., dealing with the substantive scope of treaties on estates, inheritances and gift taxes. See also M. Lang, “‘Taxes covered’ – What is a ‘tax’ according to Art. 2 OECD Model Convention?”, *Bulletin for International Fiscal Documentation* 2005, pp. 216 et seq.; id., “Der sachliche Anwendungsbereich der Doppelbesteuerungsabkommen auf dem Gebiet der Steuern vom Einkommen und vom Vermögen”, in Lang/Jirousek (eds.) *Praxis des Internationalen Steuerrechts, liber amicorum Helmut Loukota*, pp. 265 et seq.

<sup>6</sup> The current versions are: Model Tax Convention on Income and on Capital, adopted by the Council of the OECD on 15 July 2005; Model Tax Convention on Estates and Inheritances and on Gifts, adopted on 3 June 1982. Unless otherwise indicated, reference is always made to the most recent version of the respective OECD Model Convention.

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constitute what has sometimes been called an “international tax language”, reflecting a common international consensus of the contracting parties. The description of the taxes covered in Art. 2 epitomizes this global approach. As the international tax treaty network is largely based on the OECD Model Conventions, these texts are the focal point of analysis in the present study. While each treaty will necessarily be unique, as international tax law is a dynamic phenomenon of interaction between states, the common concepts expressed in the Model Conventions as well as the Commentaries serve as a sound basis in the process of treaty negotiation and thus play a major role in the interpretation of treaties that adopt the Model texts.

The approach taken in evaluating the form and substance of Art. 2 takes into account the international context of this provision and is equally informed by textual, systematic, historical and teleological factors. With a reference to the Annexes contained in this study, the legislative history of Art. 2 is analysed to gain comparative insights in the process of interpretation. Moreover, documents from the OECD archives serve to relieve ambiguities in the determination of the substantive scope of tax treaties modelled on the OECD texts.

The formulations of the current OECD Model Commentaries to Art. 2 can largely be traced back to the 1957 Reports and draft articles on substantive scope devised by the experts of WP No. 3 of the OEEC Fiscal Committee; special attention is thus given to these materials.

The second part of the thesis takes a closer look at the functional build-up of Art. 2. In treaties corresponding to the OECD Model Conventions – and in fact in the overwhelming majority of treaties forming the current global tax treaty network – the “taxes covered” under the treaty are determined according to the framework provided by the OECD Model texts, outlined in brief in the following.

Art. 2(1) defines the subject of the Convention, stipulating that the treaty applies respectively to “taxes on income and on capital” and “taxes on estates and inheritances and on gifts” that are “imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied”.

Art. 2(2) gives a somewhat imprecise description of “taxes on income and capital”; it states:

There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.”

A similarly broad description can be found in the Estates, Inheritances and Gifts MC:

There shall be regarded as taxes on estates and inheritances taxes imposed by reason of death in the form of taxes on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on donations mortis causa. There shall be regarded as taxes on gifts taxes imposed on transfers inter vivos only because such transfers are made for no, or less than full, consideration.

Art. 2(3), providing that “The existing taxes to which the Convention shall apply are in particular ...”, the contracting states list the taxes covered for each country and existing at the time of signature of the treaty. The term “in particular” clearly indicates that the list is not exhaustive. In contrast, Art. 2(3) in the Estates, Inheritances and Gifts MC does not contain the phrase “in particular”; the list therein is thus exhaustive. Some treaties do not contain a general description of the taxes covered corresponding to paras. 1 and 2 and omit the phrase “in particular” in para. 3. In these cases, the enumeration is thus exclusive as to the taxes covered under the treaty. This option to exhaustively list the taxes covered is explicitly mentioned in the OECD Income and Capital MC.

Art. 2(4) aims to prevent the treaty from instantly becoming inoperative in case changes are made to the taxation laws of a contracting party that may affect the taxes covered by the treaty. The text provides that the treaty will automatically apply to all *identical or substantially similar taxes imposed after the date of signature* of the treaty. However, no criteria are specified regarding the categorization of a tax as “identical or substantially similar”.

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Art. 2(3) and (4) are interconnected in that both contain a temporal factor: while para. 3 lists the taxes existing *at the time of signature* of the treaty, para. 4 extends the substantive scope of the treaty to identical or substantially similar taxes which are imposed *after the treaty has been signed*. The final sentence in Art. 2(4) provides that the competent authorities of the treaty partners shall notify each other of “any significant changes made in their taxation laws”.

The thesis aims to shed light on how this framework can be implemented in practice. In this context, the 1969 Report of Working Party (“WP”) No. 30 of the OECD Fiscal Committee is of particular interest: the experts of this WP analysed the structure and wording of existing tax treaties and dealt with questions regarding practical treaty application.

Contentious cases have arisen among contracting parties as to the meaning of the general description in paras. 1 and 2 in the light of the merely illustrative enumeration of taxes listed in para. 3 on the part of each contracting state. The decision of treaty partners to provide for an exhaustive listing of taxes covered, seemingly facilitating treaty application, has in equal measure given rise to unclear cases as to the scope of levies encompassed in Art. 2. Court cases in various nations have frequently dealt with issues involving the nature of “substantially similar” taxes covered at the time of conclusion of the treaty. In view of recurring unclarity in treaty application, the study seeks to elicit coherent guiding principles for the determination of the range of taxes covered.

Following the analysis of practical implications of the formal structure of Art. 2, Part III of the study delves into the substance of this provision. Based on its methodological framework and the analysis of the functional workings of Art. 2, the study proceeds to lay out the constituent conceptual foundations of the OECD Model texts on substantive scope. The thesis evaluates documents obtained from OECD archives in Florence and Paris that provide insights into various stages of the drafting history of Art. 2 in order to discover the concepts and understandings which led to the text in its present form.

The substantive scope of tax treaties is based on – in fact dependent on – the concept of “tax”; therefore, in a first step, the characteristic features of payments that qualify as “taxes” in the sense of the basic common consensus expressed in Art. 2 are sought out. In accordance with the principles of international law, the mutual adoption of the text of the OECD Model Conventions warrants the presumption that the parties have agreed to key concepts underlying the Model texts and Commentaries. The thesis uses analyses provided by experts of the League of Nations as well as Working Parties of the OEEC/OECD in order to shed light on the conceptual bases underlying the Model texts so widely followed among nations. The study also presents findings as to the concept of “tax” for purposes of other provisions in the treaty and the implications for the substantive scope described in Art. 2.

Premised on the findings with respect to the concept of “tax” in the OECD Model Conventions, the notion of taxes on “income and capital” and taxes on “estates, inheritances and gifts” respectively is given closer scrutiny. The paramount gauge for taxes covered under the treaty is that they are levied on “income and capital” or on “estates, inheritances and gifts”. However, the OECD Model Conventions lack systematic definitions of either of these terms. The range of “taxes covered” in tax treaties that adopt the Model texts is thus often unclear. The concept of “income” in tax treaties has been particularly contentious in various contexts of treaty application. The study deals with various items of “income” in domestic tax laws and their treatment under tax treaties.

Lastly, analysis turns to problems at the intersection of taxes on income and capital as dealt with in the Income and Capital MC and taxes on estates, inheritances and gifts as dealt with in the Estates, Inheritances and Gifts MC. Despite the fact that they signified the historical beginning of bilateral action against double taxation, treaties in the area of taxes on estates, inheritances and gifts are nowadays far less common. One reason for this development may be that there has been more of an international element with taxes on income and capital than taxes levied on estates, inheritances and gifts. Nevertheless, unrelieved double or multiple taxation with respect to taxes on estates,

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inheritances and gifts is an existing problem. Moreover, certain taxes are of a character that makes it difficult to determine whether they should be covered under the OECD Model Convention on Income and Capital or rather the Estates, Inheritances, and Gifts Model. An example is the replacement in several states of taxes on estates and inheritances with taxes on certain gains that may qualify as “taxes on income”. Some states levy taxes on gifts as a component of income and levy no separate gift tax.

Building on the results obtained in Part III of the study with respect to the notion of “taxes on income and capital” and “taxes on estates, inheritances and gifts”, the analysis turns on the relation between the Model Conventions and whether delineation is called for in cases of potential overlaps in substantive scope. The objective of this part is to identify cases where treaty practice can and should draw a dividing line between the two Models as to their respective substantive scope.

In conclusion of the thesis, a summary is given of the results obtained in the analysis of the fabric and conceptual grounding of Art. 2.

## 2. The approach to treaty interpretation

“A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.”<sup>7</sup>

In the application of tax treaties, especially as regards the determination whether a treaty is relevant to a certain tax at issue, the interpretation of words and phrases used in the treaty text is of paramount importance. The following methodological considerations set up the foundation of the ensuing investigation into the substantive scope of tax treaties.

Tax treaties are international agreements between two or more<sup>8</sup> countries concerning taxes; as such, they form part of international law,<sup>9</sup> a separate legal system with aims and concepts independent of those prevailing under the internal law of a single state.<sup>10</sup> Tax treaty law has established its own international rules and principles, but firmly rests upon the foundations of international law. The language used in tax treaties should therefore in principle be presumed to epitomize an international concept,<sup>11</sup> the assumption being that it has a meaning independent of domestic legal systems. The view that tax treaty terms are used in an international sense is supported by the provisions on interpretation in Arts. 31 and 32 of the Vienna Convention on the Law of Treaties,<sup>12</sup> which are

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<sup>7</sup> Justice Oliver Wendell Holmes in *Towne v. Eisner*, 245 US 418, 425 (1918).

<sup>8</sup> In the field of international taxation, attempts at the drafting of a single comprehensive multilateral treaty have so far been largely unsuccessful. See the arguments made in favour of replacing the existing bilateral tax treaty network with a multilateral treaty by Thuronyi, “International Tax Cooperation and a Multilateral Treaty”, 26 *Brook. J. Int'l L.* 2000-2001, pp. 1641 et seq. See also the comprehensive analysis in M. Lang et al. (eds.) *Multilateral Tax Treaties* (1998).

<sup>9</sup> Since about 1840, the term “international law” has replaced the older terminology “law of nations” or “*droit des gens*”. In the German, Slavic, Dutch and Scandinavian languages, the older terminology is still in use (“*Völkerrecht*”, “*Volkenrecht*”, etc.). International law has traditionally been defined as a system of equal and sovereign states whose actions are limited only by rules freely accepted as legally binding. See thereto the decision of the PCIJ in *Lotus*, Judgment No. 9 (1927) p. 18, No. 10.

<sup>10</sup> The theory of “moderate dualism”, now generally accepted in jurisprudence and academia across the nations, postulates that international and domestic law are two spheres which in principle exist as separate from each other.

<sup>11</sup> Debatin, *Auslegungsmaximen zum internationalen Steuerrecht*, AWD 1969, p. 479. Opp. Pijl, “The definition of ‘beneficial Owner’ under Dutch law”, *Bulletin for International Fiscal Documentation* June 2000, p. 256 (259). Vogel takes the approach that terms that were used in the 1963 OECD MC and were explained in the Commentary have become part of “international tax language” (see K. Vogel, “The Influence of the OECD Commentaries on Treaty Interpretation”, *Bulletin for International Fiscal Documentation* December 2000, p. 612 (616)).

<sup>12</sup> The Vienna Convention on the Law of Treaties (United Nations Treaty Series, Vol. 1155, p. 331) is an international treaty adopted on 22 May 1969 at the United Nations Conference on the Law of Treaties held in Vienna. Since the rules enshrined in this Convention have been accepted as declaratory of pre-existing international law, they are binding also on states that have not ratified the Convention. For a comprehensive insight, see Sinclair, *The Vienna Convention on the Law of Treaties* (1984).



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applicable in the same manner to tax treaties as they are applicable to any other types of international treaties.<sup>13</sup>

The vast majority of countries – Members as well as non-Members of the OECD<sup>14</sup> – have accepted the OECD Model Tax Conventions<sup>15</sup> as a guideline in their bilateral treaty negotiations, often following the Model to the letter. From the outset of the drafting of Model treaties for the prevention of double taxation, delegates from countries that did not have full membership attended the meetings and provided valuable input that considerably contributed to the shaping of the Model texts.<sup>16</sup> Since 1997, the OECD Models have included official statements of non-OECD Member countries on the articles of the Model and on the Model Commentaries.<sup>17</sup> Due to their paramount role in the practice of conclusion of tax treaties, the OECD Model Conventions are the principal item of analysis throughout the study.

The findings will in large part also be of value for treaties based on the other model treaties that have developed aside from the OECD Models. The most widely used model other than the OECD Model is the US Model Income Tax Convention.<sup>18</sup> The 1996 Technical Explanation thereto states:

[T]he United States has actively participated in the development of the OECD Model... [T]he strong identity between the provisions of the OECD and the U.S. Models reflects the fact that the United States drew heavily on the work of the OECD in the development of the U.S. Model.<sup>19</sup>

The United States was involved in the work of the OEEC from the beginning, a fact that was often emphasized by the OEEC Fiscal Committee.<sup>20</sup> The 2006 US Model has further tracked the wording of the OECD Model text; this is especially true for the provision on substantive scope.<sup>21</sup>

The development of an international tax treaty network that is largely based on the OECD Model Conventions calls for an analysis that strives to elicit common basic principles. The same methodological approach is necessary in the case of an individual bilateral treaty.

It should be noted that domestic law is by no means irrelevant at the tax treaty level;<sup>22</sup> a taxable event under domestic law is the logical prerequisite to applying a tax treaty. Tax treaties do not aim to create

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<sup>13</sup> Cf. Art. 2(1a) of the Vienna Convention on the Law of Treaties, which defines the term “treaty” and gives a non-exhaustive description of the kinds of treaties to which the Convention applies. See further F. Engelen, *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series Vol. 7 (2004) 426 et seq.

<sup>14</sup> Cf. the 2005 OECD Income and Capital Model Commentary, under B.14: “[T]he impact of the Model Convention has extended far beyond the OECD area. It has been used as a basic document of reference in negotiations between Member and non-Member countries and even between non-Member countries....”

<sup>15</sup> No material value is attributed in this study as to the designation of tax treaties as “Convention”, “Treaty”, “Agreement” since the OECD itself uses all of the above terms. Moreover, the titles of bilateral tax treaties vary, with some treaties making explicit reference in the title also to the avoidance of tax evasion. The title of a treaty will generally not be intended to be more than an indicator of its content.

<sup>16</sup> See thereto also Graetz/O’Hear, “The ‘original’ intent of U.S. International Taxation”, 46 *Duke Law Journal* (1997) p. 1023.

<sup>17</sup> Many non-OECD states have, in an Annex to the Model text, officially stated their positions on each of the Model articles as well as on the interpretations put forward in the Commentaries. Point 5 of the Introduction to this Annex states: “Whilst [the non-Member countries] generally agree with the text of the Articles of the Model Tax Convention and with the interpretations put forward in the Commentary, there are for each country some areas of disagreement.” For more details, see the OECD Annual Report for 2006, p. 60.

<sup>18</sup> The first Model Treaty was published by the US Treasury in 1977; the most recent Model was published on 15 November 2006. There is no US Model as regards taxes on estates, inheritances and gifts.

<sup>19</sup> US Department of Treasury, Technical Explanation to the US Model Income Tax Convention of September 20, 1996, Preamble.

<sup>20</sup> See e.g. the statement in the 1958 Report of the OEEC FC: “The Fiscal Committee wishes to stress the importance it attaches to the fact that Representatives of the United States ... have attended its meetings from the beginning and have taken part in its discussions.” (OEEC, Report of the Fiscal Committee on its Work, FC(58)2, Part I, m.no. 18. Hahn has noted: “It may sound oversimplified, but it is probably a correct summary of OEEC practice that the US and Canada had, de facto, the same role as the full members of the OEEC, apart from the right to vote. Yet the lack of the veto power ... has furnished them with an excellent occasion to prevent or support votes of the Council by sheer persuasion.” (Hahn, “Continuity in the Law of International Organization – Part Two: Continuity from OEEC to OECD,” DLJ 1962, p. 524).

<sup>21</sup> For more on the new US Model, see Avi-Yonah/Tittle, “The New United States Model Income Tax Convention”, *Bulletin for International Taxation*, p. 224. More of an insight into the role of the United States in the beginnings of the drafting process of the OECD Model Conventions as well as on the influence of the OECD Model has had on the US Model is provided in Lazerow, *The OECD Draft Influence on United States Income Tax Treaties* (1976).

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tax liabilities; their goal is to reduce or eliminate existing bases for taxation under the respective contracting party's internal law. In this respect, they necessarily tie in with the national provisions that allocate taxable income to taxpayers, so that the context requires the relevance of domestic law.<sup>23</sup>

The distributive rules of tax treaties, on the other hand, form a self-contained system and are therefore by their very nature barred from the application of domestic definitions and concepts. Vogel noted that “[t]ypes of income designated by treaties ... should by no means be confused with those of domestic law, even where they do exist in domestic law; any resemblance that may show up will be superficial and accidental.”<sup>24</sup> To safeguard effective application of tax treaties to domestically taxable items, the terminology of tax treaties should in principle be seen as autonomous from national phraseology.

OECD Model Conventions were drafted to facilitate “common solutions to identical cases of double taxation”.<sup>25</sup> The Model texts as well as the official Commentaries are of considerable interpretive value in that they are created by tax experts appointed to the Committee on Fiscal Affairs by the governments of Member countries. In its 1959 Report to the Council, the OEEC Fiscal Committee remarks that the favourable reception of the Model texts and Commentaries is “largely due to the fact that the Committee is composed of civil servants responsible in each Member country for the negotiation and the day-to-day administration of double taxation Conventions. The Committee is in a way a forum where problems which arise can be discussed thoroughly and constantly on a multilateral basis.”<sup>26</sup> Representatives also from non-Member countries have always been invited to the Sessions of the FC and to this day are actively involved in work of the OECD.<sup>27</sup>

With reference to the fact that the Model texts and Commentaries are not materials that originated in the context of negotiations of an individual treaty, Gloria has argued that they cannot be seen to be interpretive materials acceptable under the VCLT.<sup>28</sup> Mössner<sup>29</sup> and Lang<sup>30</sup> have convincingly countered that the fact that the Models and Commentaries will regularly be the very basis of treaty negotiations renders them important also in the interpretation of individual tax treaties.

The Model texts and Commentaries are neither binding nor can they be seen to offer ultimate solutions to treaty interpretation; still, woven through the present study is the premise that to the extent that the treaty between two contracting parties follows the structure and wording of a Model Convention, it is presumed that the parties have accepted the principles and concepts underlying the Model – unless they have made reservations to the Model texts and Commentaries. Such is also the approach taken by the OECD; an example for an explicit statement in this vein is the Report of a

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<sup>22</sup> Cf. the considerations of Becker, “Die Selbständigkeit der Begriffsbildung im Steuerrecht und ihr Einfluß auf die Auslegung der internationalen Doppelbesteuerungsverträge vom Standpunkt der deutschen Entwicklung aus betrachtet”, *StuW* 1939, p. 746 (747).

<sup>23</sup> M. Lang, “Die Einwirkungen der Doppelbesteuerungsabkommen auf das innerstaatliche Recht”, *FJ* 1988, pp. 72 et seq.; M. Lang, “Hybride Finanzierungen im Internationalen Steuerrecht” (1991) pp. 31 et seq.; Debatin, “Doppelbesteuerungsabkommen und innerstaatliches Recht, Beihefter zu Heft” 23 *DStR* 1992, p. 1 (6).

<sup>24</sup> K. Vogel, Introduction, m.no. 50. See also Vogel/Prokisch, General Report, p. 62: “Since these types of income, profit or capital are often not recognized by the domestic tax laws of Contracting States, or defined differently, it is necessary to interpret the substantive requirements in the context without reference to domestic law. The term ‘enterprise’ in Article 7 MC, for example, presupposes a common understanding in the international community.” For examples of authority in case law in this vein, see Avery Jones, “The origins of concepts and expressions used in the OECD Model and their adoption by States”, *Bulletin for International Taxation* 6/2006, p. 220 (221).

<sup>25</sup> See the Commentary on the 2003 OECD Income and Capital MC, at m.no. 2 of the Introduction: “[It is] most desirable to clarify, standardize and guarantee the fiscal situation of taxpayers in each Member country ... through the application by all Member countries of common solutions to identical cases of double taxation.”

<sup>26</sup> OEEC, The Elimination of Double Taxation – 2nd Report by the Fiscal Committee, C(59)147, published by the OEEC in July 1959, m.no. 10.

<sup>27</sup> For more information on the involvement of non-Member countries in the work of the OECD and their subscription to OECD agreements and treaties, see the homepage of the OECD Centre for Co-operation with Non-Members (CCNM).

<sup>28</sup> Gloria, *Das steuerliche Verständigungsverfahren und das Recht auf Diplomatischen Schutz* (1988) pp. 90 et seq.

<sup>29</sup> Mössner, “Zur Auslegung von Doppelbesteuerungsabkommen”, in Böckstiegel et al. (eds.) *Völkerrecht. Recht der Internationalen Organisationen. Weltwirtschaftsrecht, liber amicorum Ignaz Seidl-Hohenveldern* (1988) pp. 411 et seq.

<sup>30</sup> M. Lang, “Die Bedeutung des Kommentars und des Musterabkommens der OECD für die Auslegung von Doppelbesteuerungsabkommen”, in Gassner/Lang/Lechner (eds.) *Aktuelle Entwicklungen im Internationalen Steuerrecht* (1994) p. 15.

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Working Party to the OECD Council, noting: “It goes without saying that when the provisions of a convention merely reproduce the Articles of the O.E.C.D. Model Convention, they should in principle be interpreted in the light of the Commentaries on those Articles.”<sup>31</sup> The fact that the parties have not included an explanation for certain term or formulation used does not mean that they did not want to provide for common solutions to possible problems in this area, but rather indicates that they were unable to reach an explicit agreement.<sup>32</sup>

Ault sees the Commentaries as “a kind of ‘default’ setting for those treaties which are based on the OECD Model.”<sup>33</sup> This seems to be the view taken by the OECD Fiscal Committee<sup>34</sup> and also features in domestic jurisprudence in various countries.<sup>35</sup>

While Ault<sup>36</sup> has qualified the Model Conventions and Commentaries as comprising a “special meaning” in the sense of Art. 31(4) of the VCLT,<sup>37</sup> against the backdrop of court decisions in various countries in this vein, Waters has convincingly argued that when looking for the “ordinary meaning” of words used in tax treaties it is warranted under Art. 31(1) to take account of the international context in which the words are used, including an interpretation expressed in the OECD Model Commentaries.<sup>38</sup>

On these grounds, the view taken in the present study is that nothing is gained from attempting to classify treaty interpretation under one provision or another of the VCLT.<sup>39</sup> The interpretation provisions contained in the VCLT should be seen as a means to an end, not as an end in themselves.<sup>40</sup> Interpretation cannot be effectively subjected to legal rules,<sup>41</sup> even the Commentary on the interpretive provisions of the VCLT recognizes that interpretation is more an art than it is a science.<sup>42</sup> Whenever “rules of interpretation” are dealt with one should keep in mind that language as an expression of thought involves a process of free creation; so does any method of interpretation. In order to reveal the objective content of the term or phrase as may be inferred from the treaty text, it is crucial to use any materials available in connection with the treaty. A basic thread in the process of interpretation should be the consideration of textual, systematical, historical and teleological aspects

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<sup>31</sup> OECD, WP No. 22 of the Fiscal Committee (France-Switzerland) Second Report on Additional Studies concerning the Mutual Agreement Procedure, Paris, 7 April 1966, FC/WP 22(66)1, m.no. 10.

<sup>32</sup> Opp. Wassermeyer, “Die Auslegung von Doppelbesteuerungsabkommen durch den Bundesfinanzhof”, *StuW* 1990, p. 405.

<sup>33</sup> See Ault, “The role of the OECD Commentaries in the Interpretation of Tax Treaties”, in Alpert/Van Raad (eds.) *Essays in International Taxation* (1993) p. 65. Ward, “Principles to be Applied in Interpreting Tax Treaties”, 25 *Can. Tax J.* (1977) p. 264 m.no. 3., affirms that the Commentaries should be used unless Canada has recorded disagreement by making a reservation. See also the considerations in Chebounov, *Die Qualifikationsproblematik im deutschen Recht der DBA, Europäische Hochschulschriften Reihe II*, Vol. 3369, Peter Lang (2002) p. 73.

<sup>34</sup> OECD, Model Double Taxation Convention on Income and on Capital: Report of the Fiscal Committee, Paris (1977), Para. 29: “With regard to the reservations of states, the Committee on Fiscal Affairs considers that they must be viewed against the background of the global results which have been obtained...” This formulation has since been contained in the Commentaries to both OECD Model Conventions.

<sup>35</sup> See, e.g. the UK Special Commissioner in *UBS AG v. HM Revenue and Customs*, [2005] STC (SCD) 589, Para. 10: “[T]he negotiators on both sides could be expected to have the commentary in front of them and can be expected to have intended that the meaning in the commentary should be applied in interpreting the treaty when it contains the identical wording and neither party made an observation disagreeing with the commentary.” See also the US Court of Federal Claims in *National Westminster Bank Plc v. United States of America* (58 Fed.Cl. 491), Judgment by Judge Firestone, point B. See also the Netherlands Supreme Court, Case No. 27.252, decision of 2 September 1992.

<sup>36</sup> Ault in Alpert/Van Raad (eds.) *Essays in International Taxation*, (1993) p. 62.

<sup>37</sup> Art. 31(4) stipulates: “A special meaning shall be given to a term if it is established that the parties so intended.”

<sup>38</sup> Waters, “The relevance of the OECD Commentaries in the interpretation of Tax Treaties”, in Lang/Jirousek (eds.) *Praxis des Internationalen Steuerrechts, liber amicorum Helmut Loukota* (2005) p. 677.

<sup>39</sup> See also Jiménez, *Bulletin for International Fiscal Documentation* (2004) p. 17 (28), who argues that the distinctions made in the VCLT, rather than being mutually exclusive, are mutually reinforcing.

<sup>40</sup> See similar considerations in Malanczuk, *Akehurst's Modern Introduction to International Law* (1997) p. 131.

<sup>41</sup> Köck, *Vertragsinterpretation und Vertragsrechtskonvention* (1976) p. 101. See also M. Lang, “Die Bedeutung des Musterabkommens und des Kommentars des OECD-Steuerausschusses für die Auslegung von Doppelbesteuerungsabkommen”, in Gassner/Lang/Lechner (eds.) *Aktuelle Entwicklungen im Internationalen Steuerrecht* (1994) p. 21.

<sup>42</sup> YBILC 1966, Reports of the Commission to the General Assembly, Vol. II, p. 200, at paras. 5 and 6: “[T]he interpretation of documents is to some extent an art, not an exact science. Any attempt to codify the conditions of the application of those principles of interpretation whose appropriateness in any given case depends on the particular context and on a subjective appreciation of the varying circumstances would clearly be inadvisable. Accordingly, the Commission confined itself to trying to isolate and codify the comparatively few general principles which appear to constitute general rules for the interpretation of treaty provisions.”

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of the wording.<sup>43</sup> Sinclair has stated: “[I]t is clear that no would-be interpreter of a treaty, whatever his doctrinal point of departure, will deliberately ignore any material which can usefully serve as a guide towards establishing the meaning of the text with which he is confronted.”<sup>44</sup>

This reflects the view of the International Law Commission of the United Nations in drafting the provisions on interpretation in the Vienna Convention. In his capacity as a member of the ILC, Alfred Verdross noted that “where two States had concluded a treaty, they would not be bound by the rules in question because they could agree to use other means of interpretation.”<sup>45</sup> The ILC did not attempt to codify the many maxims of interpretation found in national and international jurisprudence but rather to give assistance in the application of such maxims, which is never an automatic process and depends on the respective circumstances.<sup>46</sup> Even prior to the codification of international treaty law, this approach was prevalent in doctrine and practice: the Permanent Court of International Justice used to consider itself free to apply whatever means of interpretation it saw fit, “as the circumstances and evidence in a particular case may require.”<sup>47</sup>

With regard to amendments to the OECD Commentaries that change the interpretation of the Model text or bring new aspects to it, there has been considerable academic dispute.<sup>48</sup> Domestic jurisprudence and administrations sometimes take into account the revised text of Commentaries but do not comment on its interpretive weight.<sup>49</sup>

It has been argued that changes to the Commentaries should be taken into consideration if they were made a long time ago and the new meaning is currently part of international tax language.<sup>50</sup> However, this approach is legitimate only where it is established that both parties have agreed to a changed interpretation. Logically, only such materials that the parties had access to at the time of conclusion of the treaty can be of relevance. An interpretation that they could not have envisioned at the time of conclusion of the treaty cannot logically be seen to be binding upon the parties; to do so would mean to go against the status of the tax treaty as an international convention between two countries. Therefore, amendments to the Commentaries cannot have an effect on treaties concluded prior to the amendments, except in cases where newer Commentaries do not reflect any change in substance but merely clarify the pre-existing line of interpretation.<sup>51</sup>

The OECD Fiscal Committee holds that “existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries”.<sup>52</sup> This statement seems to reflect practical considerations following the fact that an overwhelming majority of treaties was concluded decades ago. The Memorandum of Understanding to the tax treaty between the United States and Austria is an interesting example in support of the argument that changes in the Commentary that in effect clarify rather than change the meaning should be followed; the Memorandum states: “The Commentary – as may be revised from time to time – constitutes a means of interpretation in the sense of the Vienna

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<sup>43</sup> Cf. the approach in M. Lang, *Einführung in das Recht der Doppelbesteuerungsabkommen* (2002) m.nos. 137 et seq.

<sup>44</sup> Sinclair, *The Vienna Convention on the Law of Treaties*, Manchester University Press (1984) p. 117.

<sup>45</sup> Minutes of the 765th Meeting of the ILC, YBILC 1964 Vol. I/1, p. 279.

<sup>46</sup> See the conclusions drawn by Engelen, *Interpretation of Tax Treaties under International Law* (2004) 522.

<sup>47</sup> 29 AJIL (1935) p. 943, cited in Köck, *Vertragsinterpretation und Vertragsrechtskonvention* (1976) p. 101.

<sup>48</sup> See the conclusive summary of discussions in the OECD/IFA seminar at the 2001 IFA Congress provided in Avery Jones, “The Effect of Changes in the OECD Commentaries after a Treaty is Concluded”, 56 *Bulletin for International Fiscal Documentation* 3 (2002) p. 102.

<sup>49</sup> See, e.g. with respect to the India–US income tax treaty, the Indian Authority for Advanced Rulings (AAR) 238 ITR 296 (1999), which qualifies revised OECD Commentaries as a “useful reference ... to accommodate the emerging developments”.

<sup>50</sup> See the summary of results of a joint seminar of the OECD, IFA, the Max Planck Institute for Intellectual Property, Competition and Tax Law and the German Ministry of Finance, in Deitmer/Dörr/Rust, “Invitational Seminar on tax Treaty Rules Applicable to Permanent Establishments, in Memoriam of Prof. Dr. Berndt Runge, Seminar Report”, *Bulletin for International Fiscal Documentation* 2004, on p. 184.

<sup>51</sup> M. Lang, “Later Commentaries of the OECD Committee on Fiscal Affairs, Not to Affect the Interpretation of Previously Concluded Tax Treaties”, *Intertax* 1997, pp. 7 et seq.; M. Lang in Gassner/Lang/Lechner, *Aktuelle Entwicklungen*, pp. 24 et seq. Wattel/Marres, “The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties”, *European Taxation* 2003, p. 222.

<sup>52</sup> Introduction to the 1977 Model Commentary, m.nos. 33-36.

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Convention on the Law of Treaties.”<sup>53</sup> Austrian jurisprudence has confirmed that existing, but not later, Commentaries are to be used in tax treaty interpretation as an indication of the intention of the parties.<sup>54</sup> However, as they are devised by expert Members of the OECD Fiscal Committee and its Working Parties, even later Commentaries may be taken into consideration – on equal footing with opinions of tax experts that may be convincing.<sup>55</sup>

The approach to treaty interpretation in courts worldwide is generally a broad one that refers to a wide array of items to be taken into account as part of the treaty context.<sup>56</sup> Courts, administrators and tax advisers in the different countries have given substantial weight to the Model texts as well as the Commentaries. Whether this practice is in accordance with the rules of the VCLT has been subject to much academic dispute.<sup>57</sup> The foregoing considerations were to show that such disputes are ultimately futile. To the extent that the treaty parties adopt the text of the OECD Model Commentaries and abstain from making any observations or reservations to the Commentaries, these materials can be seen to reflect the objective intent of the parties as expressed in the treaty text.<sup>58</sup> This does not take away from the parties’ discretion to expressly agree otherwise in a Protocol or Technical Explanation to the treaty, which serve as official guides to the treaty since both parties have subscribed to its contents.

## 2.1. The importance of history: Documents from the OECD archives

The OECD Model Commentaries existing when the treaty was concluded have been described as its “legal context”.<sup>59</sup> Although it cannot be accorded the same weight in treaty interpretation as the OECD Model texts and Commentaries, written official documentation of the process that led to the adoption of the Model texts forms a “historical context” that can provide conceptual footing and valuable insights into the “spirit of the Conventions”,<sup>60</sup> and can thus guide present treaty interpretation and application. The Model Commentaries, which are indisputably the primary resource in interpretation, merely display interpretive conclusions – without any hint as to the grounds from which they were derived.<sup>61</sup>

Documents surrounding the drafting history of Art. 2 in the 1963 and 1977 Model Conventions could in principle be seen to be of value also in the interpretation of tax treaties that have adopted Art. 2 as formulated in the current 2005 Model Conventions, based on the fact that this article and the Model Commentaries thereto have not changed in substance since the first drafts for a Model text of Art. 2 were presented in 1957. It is submitted in the following that the rules of international law regarding the drafting history of international agreements<sup>62</sup> apply also in the context of the OECD Model texts.

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<sup>53</sup> Memorandum of Understanding between the United States and Austria on Interpretation of the Convention of May 31, 1996, m.no. 78. See also the considerations thereto in Avery Jones, “Are Tax Treaties Necessary?”, 1 *Tax L. Rev.* 1999, p. 61.

<sup>54</sup> Austrian Administrative Court, decision of July 31, 1996, 92/13/0172. See the discussions of this decision by M. Lang, “Later Commentaries”, *Intertax* 1997, p. 25; M. Lang, “Die Auslegung der Doppelbesteuerungsabkommen in der Rechtsprechung der Höchstgerichte Österreichs”, in Lang/Mössner/Waldburger, *Die Auslegung von Doppelbesteuerungsabkommen in der Rechtsprechung der Höchstgerichte Deutschlands, der Schweiz und Österreichs* (1997) pp. 122 et seq.

<sup>55</sup> K. Vogel, “Probleme bei der Auslegung von Doppelbesteuerungsabkommen”, *SWI* 2003, p. 110.

<sup>56</sup> See the references to Australian, New Zealand, US and UK cases in Baker, *Double Taxation Conventions* (2001) m.nos. E.04 – E.08.

<sup>57</sup> Ward, “Principles to be applied in interpreting tax treaties”, *Bulletin for International Fiscal Documentation* 1980, pp. 545 et seq.; K. Vogel, “Doppelbesteuerungsabkommen und ihre Auslegung (I)”, *StuW* 1982, p. 111 (124); Ault, “The Role of the OECD Commentary in the Interpretation of Tax Treaties”, *Intertax* 1994, pp. 144 et seq.; Jiménez, “The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries”, *Bulletin for International Fiscal Documentation* No. 58 (2004) p. 17 (18).

<sup>58</sup> M. Lang in Gassner/Lang/Lechner (eds.) *Aktuelle Entwicklungen im Internationalen Steuerrecht* (1994) p. 11.

<sup>59</sup> See Supreme Court of Canada, *The Queen v. Crown Forest Industries Ltd.*, 95 DTC 5389.

<sup>60</sup> Referral to the “spirit” of the treaty and its provisions is made throughout the Commentaries to the OECD Models. See, e.g. m.no. 8 of the 2005 Commentary on Art. 4 para. 1; m.no. 10 of the Commentary on Art. 25 (Mutual Agreement Procedure). The Mutual Agreement Procedure has from its inception been “designed to give effect to the spirit of the Convention” (explicitly stated in the Commentary to Art. 13 of the 1927 League of Nations Draft Convention for the Prevention of Double Taxation).

<sup>61</sup> M. Lang, *Einführung* (2002) p. 56.

<sup>62</sup> See generally, Pratter, “À la Recherche des Travaux Préparatoires: An Approach to Researching the Drafting History of International Agreements”, *Hauser Global Law Paper*, December 2005.

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Art. 32 of the VCLT provides that

[r]ecourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.

It is not explained, however, what the “preparatory work”, or *travaux préparatoires* as they are commonly called in international law, may comprise. From the wording, it seems that a broad coverage of materials in the context of the conclusion is intended. This view is affirmed in the Commentary of the ILC on Art. 32 VCLT, which states: “The Commission did not think that anything would be gained by trying to define *travaux préparatoires*; indeed, to do so might only lead to the possible exclusion of relevant evidence.”<sup>63</sup>

A broad take on the notion of *travaux préparatoires* is also prevalent in leading literature. McNair defines *travaux préparatoires* as “an omnibus expression which is used rather loosely to indicate all the documents, such as memoranda, minutes of conferences, and drafts of the treaty under negotiation, for the purpose of interpreting the treaty.”<sup>64</sup>

The documents from the context of the drafting of the Model Conventions of the OECD as well as the preceding OEEC<sup>65</sup> include, inter alia, the Reports of various Working Parties of the OECD’s Committee on Fiscal Affairs as well as of the Fiscal Committee of the preceding OEEC. The Fiscal Committee, replaced in 1971 by the Committee on Fiscal Affairs, was a body of tax experts and government officials from various Member countries<sup>66</sup> established to evaluate the existing worldwide treaty practice and prepare draft articles for the envisaged Model Conventions.

The Reports of Working Parties dealing with specific issues regarding the articles of the Draft Conventions were distributed regularly for consideration to governments of Member countries as well as non-Member countries for consideration, after which discussion sessions of the FC/CFA were held.<sup>67</sup> The Working Party Reports and Minutes of sessions held within the OEEC/OECD are extrinsic materials of the drafting of Model texts not of an individual treaty. Nevertheless, as Lang<sup>68</sup> has pointed out, the interpretive problems are largely analogous.

An argument against attributing value to documents from the OECD archives could be that a considerable amount of documents now accessible at the archives were originally classified as “restricted” material.<sup>69</sup> The ICJ has held that the fragmentary nature of preparatory materials means that they can only be used with caution,<sup>70</sup> however, no decision could be found by the present author as to confidential materials. While the VCLT as well as major treatises in the area of international law<sup>71</sup> do not deal with the interpretive value of materials that are not readily accessible, it has been

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<sup>63</sup> YBILC 1966, Vol. II/2, Commentary to Art. 32, m.no. 20.

<sup>64</sup> McNair, *The Law of Treaties* (1961) p. 410.

<sup>65</sup> For more on the transition from OEEC to OECD, see Hahn, “Continuity in the Law of International Organization – Part Two: Continuity from OEEC to OECD”, *Duke Law Journal* 1962, pp. 522 et seq.

<sup>66</sup> Often, the same persons represented on the FC/CFA later negotiated bilateral tax treaties for their countries. See Prang, *Die Vertragspolitik der Bundesrepublik Deutschland beim Abschluß von Doppelbesteuerungsabkommen* (1982) p. 46.

<sup>67</sup> To this day, the CFA can be seen to be “the global forum for countries to cooperate”. See the statement by Prang (1982) p. 46.

<sup>68</sup> Profound accounts on the role of materials from the Archives of the OECD can be found in M. Lang, “Wer hat das Sagen im Steuerrecht? Die Bedeutung des OECD-Steuerausschusses und seiner Working Parties”, *ÖStZ* 2006, p. 205; M. Lang, “Kommunalsteuer und DBA”, *SWI* 2005, pp. 16 et seq.

<sup>69</sup> Council Resolution of 10 July 1997 on Derestriction of Documents, C(97)64/FINAL; Council Resolution of 19 December 1991 on Archives, C(91)132/FINAL.

<sup>70</sup> *Maritime Delimitation and Territorial Questions between Qatar and Bahrain*, ICJ Reports 1995, p. 6, para. 41.

<sup>71</sup> Examples are Evans, *International Law*, 1st edn. (2003) and Brownlie, *Public International Law*, 6th edn. (2003).

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held in academic literature that an implied prerequisite to the classification of materials as part of the *travaux préparatoires* is that it was actually accessible and known to all the original parties.<sup>72</sup>

Avery Jones<sup>73</sup> found that while courts sometimes refuse to take into account evidence of confidential negotiations,<sup>74</sup> referral to such materials has been rightly accepted where such documentation is readily accessible to the parties involved.<sup>75</sup> With respect to any binding effect on the taxpayer of an understanding between the countries engaging in such negotiations, domestic courts regularly hold that a mutual understanding will be binding on the taxpayer on sole condition that it was made public.<sup>76</sup> That said, it should be noted that international law does not appear to sustain public availability in the sense of accessibility to all, rather than just the parties concerned, as a qualifying factor for *travaux préparatoires*.<sup>77</sup>

The ILC has considered whether Art. 32 VCLT should enable the use of *travaux préparatoires* only as between countries that took part in the negotiations of the multilateral treaty or, alternatively, only if they have been published, and comes to the conclusion:

A State acceding to a treaty in the drafting of which it did not participate is perfectly entitled to request to see the *travaux préparatoires*, if it wishes, before acceding. ... These considerations apply to unpublished, but accessible, *travaux préparatoires* as well as to published ones; and in the case of bilateral treaties or ‘closed’ treaties between small groups of States, unpublished *travaux préparatoires* will usually be in the hands of all the parties. Accordingly, the Commission decided that it should not include any special provision in the article regarding the use of *travaux préparatoires* in the case of multilateral treaties.<sup>78</sup>

In a 1928 case before the Permanent Court of International Justice the winning argument advanced by counsel for the French government regarding the competence of the International Labour Organization was “that Powers who took no part in the preparatory work were invited to accede to the Treaty as it stood, and did so accede, without (it may be added) having had the text of the preparatory work communicated to them.”<sup>79</sup> This has since been repeatedly affirmed in practice, the ratio being that new member countries may peruse older documents pertaining to the international treaty they are acceding to.<sup>80</sup>

Similar questions can be posed, with analogous results, regarding the acceptance of the OECD Model texts among a steadily growing number of Member countries. Presumably, new Members will scrutinize all accessible materials that give an insight into the views and process prevailing within the organization. In fact, acceding Members will more often than not look to documentation on the positions of Members as well as positions officially held within the organization so as to extensively canvass conceptual issues that may come up during Membership. This is evidenced by 1966 OECD Reports<sup>81</sup> containing questions posed by, and answers provided to, the Delegate of Japan in its role as a newly joining Member.

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<sup>72</sup> See fundamentally Köck, *Vertragsinterpretation und Vertragsrechtskonvention*, p. 92. See also Pratter, “À la Recherche des Travaux Préparatoires”, Hauser Global Law Paper, December 2005. See fundamentally Köck, *Vertragsinterpretation und Vertragsrechtskonvention*, p. 92.

<sup>73</sup> Avery Jones et al., “The Interpretation of Tax Treaties”, BTR 1981, p. 99.

<sup>74</sup> The ECJ, for example, has refused to place any interpretive value on an unpublished declaration made by a representative of the European Commission in C-8/81 *Becker v. Finanzamt Münster-Innenstadt* [1982] ECR 53.

<sup>75</sup> Avery Jones makes reference to unpublished notes taken during negotiations at a 1980 Conference of the Canadian Tax Foundation.

<sup>76</sup> See, e.g. the Danish Administrative Tax Court with respect to the Denmark–France Income and Capital Tax Treaty, Case No. 1985-5-173, decision of 22 May 1985.

<sup>77</sup> See the points made in M. Lang, “Kommunalsteuer und DBA”, SWI 2005, p. 18.

<sup>78</sup> YBILC 1966, Vol. II/2, Commentary to Art. 32, m.no. 20.

<sup>79</sup> Publications of the Court, Series B, Nos 2 and 3, p. 41, as cited by Ehrlich in *Hague Academy’s Recueil des Cours* (1928) vol. iv, p. 128, no (1).

<sup>80</sup> Rest, “Interpretation von Rechtsbegriffen in internationalen Verträgen”, Dissertation, University of Cologne (1971) p. 152.

<sup>81</sup> OECD, WP No. 25 of the Fiscal Committee, Preliminary Report on questions by the Japanese Delegation concerning the Draft Convention for the avoidance of double taxation with respect to taxes on income and capital, FC/WP 25(66)1; FC/M(66)1 under VI. (Questions raised by the Japanese Delegation); FC/M(66)2 under IV. (Questions raised by the Japanese Delegation). Cf. also FC/M(64)6 under V.: “The Delegate for Japan stated that the explanations requested were necessary as the provisions of the double taxation Conventions that Japan would be negotiating on the basis of the draft Convention established by the Fiscal Committee would become an integral part of Japanese taxation law.” (emphasis in the original)

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Therefore, in interpreting treaties concluded by OECD Member countries, it is plausible to turn to materials from the archives as accessible to the Member concerned, irrespective of accession dates. With respect to treaties concluded with non-Member countries, however, the importance of such documents will certainly not be as straightforward, and caution is to be exercised in determining the objective intent of the parties.<sup>82</sup>

In domestic jurisprudence regarding tax treaty provisions, courts regularly consider the history of a tax treaty provision so as to identify its object and purpose in the context of the treaty.<sup>83</sup> Under the VCLT, however, the role of *travaux préparatoires* appears to be limited in that recourse to such materials is acceptable only “when an interpretation according to Art. 31 leaves the meaning ambiguous or obscure” Nevertheless, this does not impose serious restrictions in court decisions, because “[o]ne can, almost by definition, assume that a dispute about the interpretation of a treaty provision ... will have arisen because the text is ambiguous or obscure.”<sup>84</sup>

The Canada Federal Court of Appeals has stated: “The Commentaries to tax conventions and other extrinsic evidence regarding the intention of the drafters of tax treaties form a part of the legal context surrounding international taxation.... Accordingly, it is clear that Commentaries to tax conventions and other evidence are to be used as an aid in the interpretation of tax treaty provisions.” The US and France are not parties to the VCLT; especially US courts have taken a very liberal view towards the use of *travaux préparatoires*.<sup>85</sup>

As has been argued in the preceding chapter, any materials that may be of use in determining the objective intent of the parties is relevant. Sinclair has rightly said: “It would be wrong to regard the principles of interpretation contained in Articles 31 to 33 of the Vienna Convention as amounting to anything more than general guidelines.”<sup>86</sup> In accordance with the principles of international law, a court, taxpayer or anyone who is interested in the meaning of the agreement, will want to consult all available materials for insight into the “common intentions and agreed definitions”<sup>87</sup> of the negotiators. As background documentation on the formation of Model texts and Commentaries provides chapters for formulations that are the basis of current treaty negotiations, it provides conclusive supplementary materials and therefore has a place in the process of interpretation.

International tax treaties are special in that to this day, the worldwide network of treaties concluded as based on the OECD Model tax treaties, the US Model Treaty, as well as the United Nations Model, is conceptually grounded in the Model texts developed by the League of Nations. The fundamental structure for international taxation laid out in the 1928 League of Nations Model Treaty forms the common basis for more than 1,200 bilateral tax treaties currently in force. Despite massive changes in the world economy, the international tax regime formulated in the 1920s has remained remarkably intact.<sup>88</sup> It is therefore of considerable value to the interpretive process to include materials documenting the deliberations of the experts arriving at the basic common consensus that is the foundation of today’s international tax system.

## 2.2. Dealing with undefined treaty terms

The Model Conventions, by their very nature, are “paragons of simplicity”,<sup>89</sup> as their goal is to provide a workable template facilitating agreement for countries with vastly disparate fiscal systems.<sup>90</sup>

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<sup>82</sup> See the statement made by M. Lang, SWI 2005, p. 18.

<sup>83</sup> See, e.g., the Swedish Supreme Administrative Court in *S. v. Tax Authorities*, Case Number 5823-1985, decision of 3 June 1986.

<sup>84</sup> Sinclair, *The Vienna Convention on the Law of Treaties* (1984) p. 142.

<sup>85</sup> See US Supreme Court, *Zicherman v. Korean Air Lines Co.*, 516 U.S. (1996) at 226: “[W]e have traditionally considered as aids to its interpretation the negotiating and drafting history (*travaux préparatoires*).”

<sup>86</sup> Sinclair, “Interpretation of Tax Treaties”, 40 *Bulletin for International Fiscal Documentation* 2 (1986) p. 76.

<sup>87</sup> Jennings/Watts, *Oppenheim’s International Law* (1992) p. 545.

<sup>88</sup> Graetz/O’Hear, “The ‘Original Intent’ of U.S. International Taxation”, 46 *Duke Law Journal* (1997) 1021.

<sup>89</sup> Sasseville, “The Role of Tax Treaties in the 21st Century”, *Bulletin for International Fiscal Documentation* 2002, pp. 246 et seq.



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Formulations tend to be broad and only very few terms are explicitly defined. Avery Jones has referred to tax treaty terminology as “boilerplate” wording,<sup>91</sup> which, however, has been conducive to the fact that the exact wording of the Models is followed in an overwhelming majority of bilateral tax treaties.

In each of the Models, Art. 3 gives general definitions of words like “person”, “property” and “competent authority”. Furthermore, the OECD Commentaries on Art. 3 point out that “some important terms [are] explained elsewhere in the Convention.”<sup>92</sup> Still, crucial terms such as “tax”, “income” or “capital gain” are not defined; moreover, existing definitions will often contain terms that remain unclear.

Most tax treaties contain a provision that can be seen as *lex specialis* to the basic interpretation provisions of the VCLT.<sup>93</sup> In the OECD Model Conventions, Art. 3(2) states that any term not defined in a treaty shall, “unless the context otherwise requires”, have the meaning that it has at that time under the domestic law<sup>94</sup> of the state applying the treaty.

The question arises whether taxpayers and tax counsellors, administrative authorities and courts may resort to notions and concepts prevailing in their respective internal legal systems to determine the meaning of terms not defined in the treaty. Art. 3(2) is unclear as to whether domestic law concepts or rather an interpretation from the context of the treaty should prevail. Opinions are divided among members of the academic community; some scholars argue that an interpretation from the context of the treaty is warranted<sup>95</sup> while others deem instant recourse to domestic law preferable.<sup>96</sup>

The position taken in this thesis is that a term used in tax treaties between countries with diverse legal systems should be given an international meaning, consistent with the international fiscal context it is used in, rather than a meaning dependent on the domestic law of one of the contracting parties.

In a recent study on the origin of expressions used in the OECD Model, Avery Jones et al. have found that the formulation “unless the context otherwise requires” has a common law origin. They conclude that this expression is unnecessary as applied to civil law countries since it is implied by way of

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<sup>90</sup> In a letter to the Chairman of the League of Nations Fiscal Committee of April 12, 1927, the Chairman of the Committee of Technical Experts on Double Taxation and Tax Evasion, Pasquale d’Aroma, stated: “[H]aving regard to the diversity of the legislative systems represented in the Committee, and the necessity for finding formulae capable of acceptance by everyone, it will be recognized that the experts were bound to confine themselves to indicating general rules, leaving particular points of difficulty to be dealt with – *in the spirit of the accepted general principles* – by those on whom the task of negotiating the bilateral conventions will ultimately fall.” (emphasis added)

<sup>91</sup> Avery Jones, “The Multiple Amendment of Bilateral Double Taxation Conventions”, *Bulletin for International Taxation*, “Tax Treaty Monitor”, January 2006, p. 19.

<sup>92</sup> See the Income and Capital Model Commentary and the Estates, Inheritances and Gifts Model Commentary on Art. 3, each in Para. 1. In the Income and Capital Model, the terms “resident” and “permanent establishment” are defined in Arts. 4 and 5, respectively, while the distributive articles on special categories of income clarify the terms therein (“immovable property”, “dividends”, “royalties”, etc.). The Estates, Inheritances and Gifts Model defines “domicile” in Art. 4; the meaning of certain terms used in other articles (“immovable property”, “permanent establishment”, “nationals”) is clarified by the provisions of those articles.

<sup>93</sup> The 1981 US Model Income Tax Treaty contains a provision corresponding to that in the OECD Model. For more on the interpretation article in US tax treaties, see Shannon, “United States Income Tax Treaties: Reference to domestic law for the meaning of undefined terms”, *Intertax* 1989/11, pp. 453 et seq.

<sup>94</sup> According to the Commentary on Art. 3 Para. 2, at m.no. 13.1, the reference is to “any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others....”

<sup>95</sup> M. Lang, “Die Einwirkungen der Doppelbesteuerungsabkommen auf das innerstaatliche Recht”, FJ 1988, pp. 72 et seq.; M. Lang, “Irrwege der DBA-Auslegung am Beispiel der Besteuerung von Lehrbeauftragten – Off-track Interpretation of Double Taxation Treaties as Exemplified by the Taxation of Lecturers”, SWI 1998, pp. 508 et seq.; Debatin, “Doppelbesteuerungsabkommen und innerstaatliches Recht”, *Beihefter zu Heft 23 DStR* 1992, 1 (6); Blumenstein, *System des Steuerrechts* (1995) p. 35; Rivier, *Droit fiscal international*, pp. 99 et seq.

<sup>96</sup> H. Loukota, “Tax Treatment of Short-term Teaching Activities of University Professors”, SWI 1998, pp. 456 et seq.; H. Loukota, “Vermeidung von Irrwegen bei der DBA-Auslegung”, SWI 1998, pp. 559 et seq. Wassermeyer in Debatin/Wassermeyer, “Commentary on Art. 4”, m.nos. 88 et seq., suggests recourse to domestic law prior to efforts to derive an interpretation from the context of the treaty.

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systematic interpretation.<sup>97</sup> The usefulness of the phrase can indeed be called into question as it has led to confusion as to the extent to which domestic tax law provisions might supersede treaty definitions.

Interestingly, the provision of Art. 3(2) has sparked controversy over its usefulness and application from early on; during a 1965 Session, the following remarks were made by the Delegates to the OECD Fiscal Committee:

The Delegate for Denmark ... considered that a common interpretation of the O.E.C.D. Draft Convention was essential and that only an international authority could give one.... The Delegate for Austria, while endorsing the views of the Delegate for Denmark on the need for a uniform interpretation, said that it was the domestic law which gave rise to the most serious difficulties.... The Delegate for Germany, pointing out that Article 3, paragraph 2, of the Draft Convention referred to the definitions in the domestic laws, thought that the elaboration in the Convention of rules and definitions that were as precise as possible would limit differences as to interpretation. The Delegate for Belgium supported the remark of the Delegate for Germany, and pointed out that, in adopting Article 3, paragraph 2, the Committee had created a source of difficulty that it must now remove.<sup>98</sup>

The provision has not been removed from the Model Conventions; nor were the definitions in Art. 3(1) elaborated on. However, Art. 3 is to be interpreted in accordance with the general principles of interpretation in international law.

Under Art. 31(1) of the Vienna Convention, a term is to be interpreted “in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” The ICJ has held this to constitute customary international law.<sup>99</sup> The materials to the Convention<sup>100</sup> state that “ordinary meaning” is to be understood in the context of the special scope in which a term is applied, which actually indicates that the term will have a “special” meaning depending on its respective context as well as the underlying object and purpose.<sup>101</sup>

The meaning of a term can only be ascertained by reference to the particular legal framework from which it has derived its substance. There is no obligation under the treaty for one state to adopt the interpretation given to a term in the other state, because such line of thought is not compatible with the object and purpose of tax treaties. Vogel argued that an interpretation in light of the object and purpose of a treaty requires that “states should seek the treaty interpretation which is most likely to be accepted in *both contracting states* (the goal of ‘*common interpretation*’).”<sup>102</sup> The context of tax treaty terms calls for them to be regarded as expressing a common international understanding of the parties.

The term “context” as used in Art. 3(2) seems to have a broader meaning than “context” mentioned in Art. 31(1) of the Vienna Convention. The Income and Capital Model Commentary on Art. 3(2) states: “The context is determined in particular by the intention of the Contracting States when signing the Convention....”<sup>103</sup> The Commentary does not explain on what basis it names the intention of the parties in this declaratory enumeration. To ascertain the intention of the parties has always been regarded an important factor in the interpretation of international treaties. While there used to be a dispute among international legal scholars whether the primary object of interpretation should be the “true” intentions of the parties<sup>104</sup> rather than the objective treaty text,<sup>105</sup> the commonly accepted approach is one that aims to derive the “objective intent” of the contracting parties.<sup>106</sup>

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<sup>97</sup> Avery Jones et al., “The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States”, *Bulletin for International Taxation* June 2006, p. 220 (221).

<sup>98</sup> OECD, Fiscal Committee, Minutes of the 21st Session held in Paris on Tuesday 28th, Wednesday 29th, Thursday 30th September, and Friday 1st October, 1965, FC/M(65)3, Paris, 22nd October 1965, p. 3 (“General Remarks”).

<sup>99</sup> See e.g. the judgment in *Islamic Republic of Iran v. United States of America*, ICJ Reports 1996, p. 803. para. 23.

<sup>100</sup> Para. 17 of the Commentary to Art. 27 of the ILC Final Draft.

<sup>101</sup> Cf. the approach taken in statutory interpretation in common law jurisdictions, which distinguishes between the “ordinary English meaning” of words as opposed to their “technical meaning”.

<sup>102</sup> K. Vogel, Commentary, Introduction, m.no. 74. (emphases in the original)

<sup>103</sup> Model Commentary on Art. 2, m.no. 12.

<sup>104</sup> *J.N. Gladden Estate v. The Queen* (1985) 1 C.T.C. 163 (F.C.T.D.) 166-167: “[A] treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties.” See also the US Supreme Court in as early as 1895, *United States v. Texas*, 162 U.S. 1, at 36-37: “Undoubtedly, the intention of the two governments, as gathered from the words of the

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The Commentary of the ILC to the VCLT notes that “the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intentions of the parties”.<sup>107</sup> Proclaimed subjective intentions of the parties will thus only be of relevance if expressed in the wording of the treaty in light of the surrounding circumstances.

The VCLT never mentions in its exhaustive list the intention of the parties; rather, Art. 31(2) stipulates a somewhat narrow notion of “context”, comprising the text of the treaty itself as well as any protocol and other instrument made in connection with the conclusion of the treaty. Still, there are no grounds to view the VCLT as being in conflict with Art. 3(2) of the OECD Model Conventions. The methods of interpretation set forth in the VCLT do not differ fundamentally from the basic methods prevailing in any other area of law, nationally or internationally.<sup>108</sup> In his groundbreaking thesis on the interpretation of tax treaties under international law, Engelen submits that Art. 3(2) concretizes the application to tax treaties of the general rule of interpretation embodied in Art. 31 VCLT.<sup>109</sup>

Some authors have argued that the term “requires” in the wording “unless the context otherwise requires” of Art. 3(2) presupposes that an interpretation from the context of the treaty is appropriate only if there are compelling reasons to this effect.<sup>110</sup> Such approach is by no means justified with a view to the object and purpose of tax treaties. Even though interpretation will in practice always be influenced to a certain extent by the approach taken in domestic law,<sup>111</sup> it would undermine the purpose of tax treaties as international agreements not to see as the ultimate goal a uniform application of their rules.

The terms used in Art. 3(2) are to be interpreted in accordance with the ordinary meaning given to them in their context, and with regard to the object and purpose of the treaty. Instant recourse under Art. 3(2) to the domestic law meaning of a term would clearly thwart the object and purpose of tax treaties as per Art. 31(1) of the VCLT: If a term is understood by either of the treaty partners according to definitions in their respective domestic legal systems, “qualification conflicts”<sup>112</sup> are inevitable, which might entail double taxation or “double non-taxation.” Moreover, an opportunity to take domestic concepts to the international level would enable states to unilaterally influence their obligations under the treaty. Recourse to domestic concepts does not enhance clarity; on the contrary, a term might not even bear any meaning under a country’s domestic law.<sup>113</sup> The term “context” as used in Art. 3(2) of the OECD Models should be seen to have the broadest possible meaning, with

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treaty, must control; and the entire instrument must be examined in order that the real intention of the contracting parties be ascertained.”

<sup>105</sup> For more on this see Köck (1976) p. 27, citing a statement of the Permanent Court of International Justice from the PCIJ-Publications of 1931: “The Court is not prepared to adopt the view that the text of the treaty ... can be enlarged by reading into it stipulations which are said to result from the proclaimed intentions of the authors of the treaty, but for which no provision is made in the text itself.”

<sup>106</sup> Cf. K. Vogel, Introduction, m.no. 69-69a; Wassermeyer in Debatin/Wassermeyer, *Doppelbesteuerung*, Art. 3 m.no. 78.

<sup>107</sup> YBILC 1966, Vol. II/2, p. 220.

<sup>108</sup> Fundamentally Rill, “Juristische Methodenlehre und Rechtsbegriff”, ZfV 1985, pp. 461 et seq.; see also Gassner, *Tax Avoidance/Tax Evasion, Cahiers de droit fiscal international*, Vol. 68a, p. 250.

<sup>109</sup> Engelen, *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series Vol. 7 (2004) 482.

<sup>110</sup> Van Raad, “The Term ‘Enterprise’ in the Model Double Taxation Conventions”, *Intertax* 1994, at p. 493: “However, the word ‘requires’ in Article 3(2) indicates that not just any treaty contextual meaning has priority.” See also the view taken in Pijl, “The Definition of ‘Beneficial Owner’ under Dutch Law”, *Bulletin for International Fiscal Documentation* 2000, p. 259.

<sup>111</sup> Generally speaking, it can be observed that Continental European legal scholars are traditionally more accustomed to working with different elements of interpretation, and civil law courts refer far more readily and frequently to the preparatory materials or legal history of a text than common law courts would.

<sup>112</sup> This expression is used in international tax literature to describe situations where the contracting states apply different articles of the treaty on the basis of differences in their respective domestic laws.

<sup>113</sup> Moreover, the authentic treaty text will in many cases be expressed in a language different to that in which each contracting state’s tax laws are expressed; see Edwardes-Ker, *Tax Treaty Interpretation*, Chap. 7, at p. 2. See also M. Lang, “Qualifikationskonflikte im Recht der Doppelbesteuerungsabkommen”, in Kirchhof et al. (eds.) *Staaten und Steuern, liber amicorum Klaus Vogel* (2000) pp. 922 et seq.

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recourse to domestic concepts to be had only in the scarcest of cases.<sup>114</sup> Art. 3(2) merely emphasizes that an interpretation of treaty terms from their international context should always prevail over domestic definitions.<sup>115</sup>

According to an often quoted statement of the US Tax Court on tax treaty interpretation, “The clear import of treaty language controls unless application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectation of the signatories.”<sup>116</sup>

In its Art. 2(2), the VCLT explicitly provides that “[t]he provisions of paragraph 1 regarding the use of terms in the present Convention are without prejudice to the use of those terms or to the meanings which may be given to them in the internal law of any state.” The “ordinary meaning” of tax treaty terms in the sense of the VCLT can only be revealed with regard to their international context. Guidance should equally be sought from the terminology of the treaty as a whole, its structure and systematic build-up, the function of the article in question, its historical context as well as other circumstances that may be relevant. The objective of treaty interpretation is to “give the specific words of a treaty a meaning consistent with the shared expectations of the contracting parties.”<sup>117</sup>

A significant deficiency in this context is the lack of an international body to enforce consistent interpretation in all nations.<sup>118</sup> Terms in tax treaties often appear to be left deliberately open, as states plan on addressing problems when they arise, retaining the best possible bargaining position in negotiations between their respective administrative authorities.<sup>119</sup> Avery Jones has ascribed the lack of harmonization in domestic tax laws to the said practices in treaty negotiations: “The reason why treaties do not lead to useful harmonization of tax laws is what normally is referred to as sovereignty, but is really the need to preserve one’s negotiating position.”<sup>120</sup>

In the absence of institutions competent to render authoritative interpretations that would be binding on the states, it cannot be denied that all international law is somewhat relative and conceptual problems are intrinsic.<sup>121</sup> The vast majority of existing tax treaties contain a provision for mutual agreement in case of disputes that corresponds to Art. 25(3) of the OECD Income and Capital MC, stating that “[t]he competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.”<sup>122</sup> This procedure, however, has significant shortcomings<sup>123</sup> and usually does not reap clear-cut definitions binding upon both states. In the Model Commentaries to Art. 25, the OECD Committee on Fiscal Affairs acknowledged that albeit unsatisfactory, this article has been the maximum the Member countries could agree on.<sup>124</sup>

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<sup>114</sup> This approach is frequently taken in jurisprudence; see, e.g., Canada Federal Court of Appeal, *Cudd Pressure Control, Inc. v. Her Majesty the Queen*, 98 TNI 206-19, m.no. 19: “Article 3(2) of the OECD Convention [establishes] that where a term is not defined in a bilateral tax treaty, definitions from domestic income tax law should be applied UNLESS THE CONTEXT INDICATES OTHERWISE.” [upper-case in the original] See also the Finnish Supreme Administrative Court, Case No. 2004:116, decision of 22 December 2004. Further references to court decisions in various nations are found in Edwardes-Ker, *Tax Treaty Interpretation* (1995) Chap. 7, p.12.

<sup>115</sup> M. Lang, *Doppelbesteuerungsabkommen und innerstaatliches Recht* (1992) p. 105.

<sup>116</sup> *SumitomoShoji Am., Inc. v. Avagliano*, 457 US 176, 180 (1982), quoting *Maximov v. US*, 373 US 49 (1963) at 54.

<sup>117</sup> *Maximov v. US*, 373 US 49 (1963).

<sup>118</sup> Cf. the considerations in Rest, *Interpretation von Rechtsbegriffen in internationalen Verträgen*, p. 209.

<sup>119</sup> Debatin has stated that the contracting parties will often aim to leave themselves a backdoor for settling differences in interpretation in the form of the mutual agreement procedure (see Debatin, AWD 1969, p. 478).

<sup>120</sup> Avery Jones, “Are Tax Treaties Necessary?”, *Tax L. Rev.* 1999, Vol. 1, p. 54.

<sup>121</sup> See also the considerations by D. Shelton, “International Law and ‘Relative Normativity’”, in Evans (ed.) *International Law* (2003) p. 145 (146).

<sup>122</sup> Cf. the corresponding provision in Art. 11(3) of the OECD Model Convention on Estates and Inheritances and on Gifts. See also the OECD Report on Mutual Agreement Procedure (1984), at Paras. 39 and 40.

<sup>123</sup> For an in-depth analysis, see Avery Jones et al., “The legal nature of the mutual agreement under the OECD Model Convention (I)”, BTR 1979, pp. 337 et seq.; see also IFA, *Mutual Agreement – Procedure and Practice*, *Cahiers de droit international*, Vol. 66a (1981); Skaar, “The legal nature of mutual agreements under tax treaties”, 5 *Tax Notes International* 26 (1992), pp. 1441 et seq.; M. Züger, “Mutual Agreement and Arbitration Procedure in a Multilateral Tax Treaty”, in M. Lang et al., *Multilateral Tax Treaties – New Developments in International Tax Law* (1998) pp. 153 et seq.

<sup>124</sup> Para. 45 of the OECD Model Commentary on Art. 25(3).

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The 1928 League of Nations Draft Conventions contained a provision<sup>125</sup> that established, in case amicable settlement by the parties could not be reached, the appointment of

such technical body as the Council of the League of Nations may appoint for this purpose. This body will give an advisory opinion.... The Contracting States may agree ... to regard the advisory opinion given by the said body as final. In the absence of such an agreement ..., they shall be free ... to have recourse to any arbitral or judicial procedure which they may select, including reference to the Permanent Court of International Justice.

Now as well as then, such authorization to submit disputes to an international court does not bode well with governments.

Suggestions for an international judicial or arbitral mechanism have arisen throughout the work of the OECD in the field of double taxation. A 1966 Report of WP No. 22 to the Council of the OECD states: "In reality, it would be necessary not only to make the mutual agreement procedure mandatory whenever a difficulty of interpretation arose, but also, and above all, ... a procedure would be necessary for referring such cases to some higher authority, whose decisions would be binding on both states."<sup>126</sup> The Report proposed as alternative solutions an "independent arbitrator [who] would necessarily have to be an eminent person of unquestionable impartiality", as well as a "committee of jurists, composed of a number of eminent specialists in taxation law from different countries and whose decisions would be conclusive."<sup>127</sup> Despite clear rejection on the part of most Member countries, the WP voiced optimism:

[I]t may be expected that as international co-operation becomes a matter of course, the present resistance to any relinquishment of sovereignty – even in matters of taxation – will gradually become weaker and one day – which one may hope will not be too far distant – the Fiscal Committee of the O.E.C.D. will once again be able to consider the question....<sup>128</sup>

The International Fiscal Association has supported pleas in academic literature for an "international tax court".<sup>129</sup> Moreover, there have been suggestions to involve the International Court of Justice and the European Court of Justice in tax treaty dispute resolutions.<sup>130</sup> The tax treaty between Austria and Germany of 2000 is unique in that it refers interpretation conflicts that cannot be resolved under the mutual agreement procedure to the European Court of Justice as an arbitral body;<sup>131</sup> however, thus far, not a single case has been submitted to the ECJ. Van Raad has proposed the creation of an international panel of tax treaty experts that might be called upon by courts and administrative authorities to give an opinion on the interpretation of a treaty provision in the respective case at issue.<sup>132</sup>

The prevailing judgment among scholars is that an international tax court is currently not a realistic option,<sup>133</sup> and chances for the realization of mentioned suggestions are bleak. Recent treaties of the

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<sup>125</sup> Art. Art. 13 of Draft Convention No. IC of the Draft Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes; Art. 6 of the Draft Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties.

<sup>126</sup> Second Report of WP No. 22 (France–Switzerland), which dealt with the issue of "Protection of tax-payers under Article 25"; FC/WP 22(66)1, m.no. 68. The vast difference in opinions of the experts as to the nature and role of such a body is evidenced in m.nos. 74–79 of same Report.

<sup>127</sup> *Id.*, m.nos. 69 and 71, resp.

<sup>128</sup> *Id.*, m.no. 68.

<sup>129</sup> The question was discussed at length at the 5th Congress of IFA in Zurich in 1951. For more on the topic, see Azzi, "Tackling Tax Treaty Tensions: Time to Think about an International Tax Court", 52 *Bulletin for International Fiscal Documentation* 8-9 (1998) pp. 348 et seq.

<sup>130</sup> See, for example, E. van der Bruggen, "Compulsory Jurisdiction of the International Court of Justice in tax cases: Do we already have an 'International Tax Court'?", *Intertax* 8-9 (2001), pp. 250 et seq.

<sup>131</sup> See M. Züger, "The ECJ as Arbitration Court for the New Austria-Germany Tax Treaty", 40 *European Taxation* 3 (2000) pp. 101 et seq.

<sup>132</sup> Van Raad, "International Coordination of Tax Treaty Interpretation and Application", *Intertax* 2001, pp. 212 et seq., who rejects the idea of a mandatory arbitration system; arguing in favour of internationally binding arbitration to supplement the mutual agreement procedure: A. Ribes Ribes, "Compulsory Arbitration as a Last Resort in Resolving Tax Treaty Interpretation Problems", *European Taxation* September 2002, pp. 300 et seq.

<sup>133</sup> See, inter alia, M. Edwardes-Ker, *The International Tax Treaties Service*, loose-leaf edn (1994), Chap. 2, p. 2.01; M. Waters, "The relevance of the OECD Commentaries in the Interpretation of Tax Treaties", pp. 671 et seq. (674).

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United States with Canada and Germany require that the competent authorities of the contracting parties submit a matter to arbitration if they are unable to reach complete agreement within a 2-year period; however this applies only to certain specified matters, i.e. matters involving residency, permanent establishment, business profits, transfer pricing and royalty issues.<sup>134</sup> Disputes as to the substantive scope of the treaty are not directly addressed and it will be interesting to see how an arbitral tribunal established under the treaty might handle matters that implicate substantive scope.

It is submitted, and substantiated throughout the study at hand, that treaty application should start from the recognition of the parties' common consensus on concepts underlying the OECD Model texts where they have not stipulated otherwise. To interpret a tax treaty with reference only to domestic tax law and concepts would mean to gravely oversimplify treaty application. It may often be difficult to derive an international fiscal meaning of a treaty term from the context within which it is used,<sup>135</sup> and even within the treaty, a term might have different meanings when used in different provisions.<sup>136</sup> Still, these interpretive efforts have to be undertaken to do justice to the internationality of terms used in tax treaties and to avert looming "qualification conflicts". Therefore, the best way to carry into effect the goals of the OECD Model Tax Conventions is to interpret terms in treaties that correspond with the wording of these templates against the backdrop of the *common international consensus* reflected in the Model Conventions.

The interpretation of a tax treaty between two countries should factor in other tax treaties and international agreements concluded by each of the parties.

Considerable influence can be ascribed to EC law. While the intricacies of interaction between tax treaties and EC law in the field of direct taxation are in large part contentious,<sup>137</sup> EC law explicitly acknowledges the importance of bilateral treaties for the prevention of double taxation.<sup>138</sup> EC Member States are largely free to enter into agreements in the area of taxes as they see fit. The ECJ noted in *Gilly*:

The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation-by means, inter alia, of international agreements – and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the OECD.<sup>139</sup>

In *Saint-Gobain*, the Court emphasized that "in the absence of unifying or harmonising measures adopted in the Community ... the Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation."<sup>140</sup>

As EC law is superior to national laws and even to Member States' constitutions,<sup>141</sup> it is clear that tax treaties concluded between EC Member states must be consistent with the provisions of EC law and the jurisprudence of the ECJ, and Member states must not violate EC law in contracting with non-

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<sup>134</sup> See Art. 21 of the 2007 Fifth Protocol to the United States–Canada Income Tax Treaty.

<sup>135</sup> The term "enterprise", for example, has different meanings depending upon the respective provision it is used in: see van Raad, "The Term 'Enterprise' in the Model Double Taxation Conventions – Seventy Years of Confusion", in Alpert/van Raad (eds.) *Essays on International Taxation, liber amicorum Sidney I. Roberts* (1994) pp. 317 et seq.

<sup>136</sup> *Id.*

<sup>137</sup> Williams, *EC Tax Law* (1998) p. 17. M. Lang, "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts", in Gassner/ Lang/Lechner (eds.) *Doppelbesteuerungsabkommen und EU-Recht* (1996) p. 25. For a recent analysis into the subject, see Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (2007).

<sup>138</sup> Art. 293 EC Treaty. See also the references to bilateral treaties in the EU Mergers Directive (90/434/EEC) and the Parent-Subsidiary Directive (90/435/EEC).

<sup>139</sup> C-336/96, *Mr. and Mrs. Robert Gilly v. Directeur des services fiscaux du Bas-Rhin*, Judgment of 12 May 1998, ECR 1998, p. I-02793.

<sup>140</sup> C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, Judgment of 21 September 1999, ECR 1999, p. I-6161.

<sup>141</sup> The doctrine now known as the supremacy of EC law emerged from the decision of the ECJ in *Flamino Costa v. ENEL* [1964] ECR 585, 593.

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Member states.<sup>142</sup> Especially in the areas of non-discrimination and the fundamental freedoms laid down in the EC Treaty, intersections with tax treaty law may occur.<sup>143</sup>

Moreover, as the way in which taxes are levied will also influence international trade,<sup>144</sup> provisions of the GATT and WTO Agreements are to be factored in, particularly in the area of non-discrimination; in some areas the distinction between tax law and trade law seems to be blurring.<sup>145</sup> This holds true also for the relation between tax treaties and bilateral agreements concluded in the area of social security coordination, sometimes called “totalization agreements”.<sup>146</sup> The issue of EU Member States moving gradually towards funding social security schemes from taxation leads to problems in the application of tax treaties with a view to EC legislation on the coordination of social security payments and benefits.<sup>147</sup>

With the international context in mind, it is all the more important to advocate that terms used in treaties that correspond to the Model texts are to be seen as reflecting a common international consensus<sup>148</sup> of the contracting states. This approach best serves the goal of determining the ordinary meaning of a treaty term in the international treaty context and serves the object and purpose of treaties concluded along the lines of the OECD Model Conventions. Moreover, it is the only way to bring about consistency in treaty application, which has been a key objective of the OECD.

### 2.3. The role of domestic court decisions in interpretation

A recent congress of the International Fiscal Association (IFA) dealt with the use of foreign court decisions by domestic courts in interpreting tax treaties in more detail than is possible in the present context.<sup>149</sup> The OECD as well as its predecessor, the OEEC, have stressed the desirability of uniform interpretation of tax treaty provisions patterned on the OECD Model text. Therefore, unilateral administrative rulings, parliamentary materials or statements by a treaty partner’s taxation authorities per se cannot be decisive in treaty interpretation. Nevertheless, such materials are useful as evidencing the respective party’s expectations and understanding of the terms of the treaty at the time of conclusion, which can help to clarify the common international consensus expressed in common treaty language.

Caution must be exercised nevertheless where such materials bear on substantive treaty provisions resulting from bilateral negotiations. These are extrinsic materials, which, according to Art. 32 of the

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<sup>142</sup> The ECJ has consistently held that although “direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law”. See, for example, C-279/93 (*Schumacker*), m.no. 21; C-80/94 (*Wielockx*), m.no. 16.

<sup>143</sup> For an extensive analysis of the fundamental freedoms, see Barnard, *The Substantive Law of the European Union: The Four Freedoms* (2004). A concise account of the impact of non-discrimination rules of the EC Treaty on national tax systems is given in Lang/Schuch/Staringer, *Die Diskriminierungsverbote im Recht der Doppelbesteuerungsabkommen* (2006). An evaluation of problems at the intersection of international tax law and EC law can be found in Lang/Schuch/Staringer (eds.) *Tax Treaty Law and EC Law* (2007).

<sup>144</sup> Schön, “World Trade Organization Law and Tax Law”, *Bulletin for International Fiscal Documentation* July 2004, p. 283.

<sup>145</sup> Li, “Relationship Between International Trade Law and National Tax Policy: Case Study of China”, *Bulletin for International Fiscal Documentation* February 2005, p. 77. For more insight into this topic, see Lang/Schuch/Staringer (eds.) *WTO and Direct Taxation* (2005).

<sup>146</sup> A comparative analysis from the perspective of numerous countries can be found in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006). For general considerations on distinguishing the areas of international tax law and international social security law, see K. Vogel, “Internationales Sozialrecht und Internationales Steuerrecht im Vergleich”, in Ruland et al. (eds.) *Verfassung, Theorie und Praxis des Sozialstaats, liber amicorum Hans F. Zacher*, pp. 1173 et seq.

<sup>147</sup> See Pieters, *Social Security, Taxation, and European Integration* (1992) p. 235.

<sup>148</sup> Cf. Edwardes-Ker at p. 3. See also Prokisch, “Does it Make Sense if We Speak of an ‘International Tax Language?’”, in K. Vogel (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, Series on International Taxation (1998) p. 103 (104). Similar views are held in Rest, pp. 179 et seq., and in K. Vogel, “The Influence of the OECD Commentaries on Treaty Interpretation”, *Bulletin for International Fiscal Documentation* 2000, p. 612 (616).

<sup>149</sup> See further *Bulletin for International Taxation* “Tax Treaty Monitor” of January 2009, p.4, as well as the extensive study of this topic provided by David A. Ward, “Use of Foreign Court Decisions in Interpreting Tax Treaties”, in G. Maisto (ed.) *Courts and Tax Treaty Law*, IBFD (2007).

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VCLT, may only be used to interpret the treaty in cases of doubt. Justice Graham Hill, judge of the Federal Court of Australia, noted that

[i]f the language of the treaty itself is clear, there should in any event be no reason to access extrinsic material... [S]ince most double taxation treaties follow, although with some modification, one or other of the model conventions [US or OECD Model], most usually the OECD Model, and since the model conventions are issued with a commentary, recourse may be had to that commentary in interpreting a tax treaty clause which adopts the model or even in interpreting a clause which departs from the model. Where a state has filed reservations to the commentary or made particular comments concerning a particular commentary, clearly such reservations or comments would necessarily be relevant to the interpretation of a particular treaty which adopted the model in a relevant respect.<sup>150</sup>

Since the vast majority of tax treaties concluded worldwide is based on the OECD Model texts, treaties regularly share identical or closely similar terminology, leaving the respective parties with shared interpretive challenges. A contracting party will usually monitor the other party's domestic court decisions that are of import to treaty application.

Baker has taken the position that courts should follow decisions of authorities of other states regarding treaty interpretation, "unless they are convinced that the other decisions are incorrect."<sup>151</sup> While there is no explicit legal basis for such practice in the VCLT, it is a common practice in international law when dealing with multinational treaties to refer to foreign court decisions so as to derive a common interpretation.

Moreover, from a practical standpoint it is feasible to accord weight to the interpretation of similar treaty provisions in other countries. This goes beyond the need for common interpretation of a treaty as between its contracting parties: If a contracting party has concluded treaties with other nations that employ the same terminology, administrative rulings and court decisions concerning the interpretation of these treaties, albeit not binding on courts in the other contracting state, should be considered in interpretation. As tax treaties result from specific negotiations between two contracting parties, the argument for universal interpretation of treaty terms appears to be less strong than in the case of multilateral treaties. The idea of a multilateral convention to prevent international double taxation was first expressed within the League of Nations.<sup>152</sup> In 1931, proposals for the text of a Draft Plurilateral Convention were presented by the experts of the League of Nations Fiscal Committee.<sup>153</sup> All efforts in this vein went unheeded and were eventually disregarded by the OECD as unlikely in practice.<sup>154</sup> Nevertheless, the widespread adherence to the OECD Model texts in treaties around the globe is evidence of a common conceptual consensus that takes the process of treaty interpretation beyond a mere analysis of bilateral bargaining positions.

Rosenbloom, contrary to Baker's view, argued that those responsible for interpreting a treaty must ascertain and implement the treaty bargain rather than develop an approach that will reduce all treaties

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<sup>150</sup> Justice Graham Hill, "The Interpretation of Double Taxation Agreements – The Australian Experience", *Bulletin for International Fiscal Documentation* 2003, 320 (324).

<sup>151</sup> Baker, Commentary, C-28, note 3.

<sup>152</sup> See League of Nations, Fiscal Committee, Report to the Council on the Work of the First Session of the Committee (1929), under Chapter V.: "The Committee unanimously agreed that bilateral conventions only constitute a partial solution of the problem of double taxation. Though recognizing that this solution appears at the present time in most cases to be the only possible one, the Committee felt that it should always be borne in mind that multilateral conventions would be better calculated to secure the desired unity of method and principle. It therefore thinks that an endeavour should be made to conclude such conventions as soon as agreement, even on a limited scale, seems to be possible."

<sup>153</sup> League of Nations Fiscal Committee, Report to the Council on the Work of the Third Session of the Committee, C.415.M.171.1931.II.A, Geneva, 6 June 1931, Appendix I: Draft Plurilateral Convention for the Prevention of the Double Taxation of Certain Categories of Income; Appendix II: Draft Plurilateral Convention "A" for the Prevention of the Double Taxation of Certain Categories of Income; Appendix III: Draft Plurilateral Convention "B".

<sup>154</sup> See point C, m.no. 37-40 of the 2003 OECD Model Commentary on the Income and Capital MC, in particular under 40: "[T]here are no reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered practicable. The Committee therefore considers that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level." The multilateral approach has been successful as regards the Nordic countries; see the Nordic Convention on Income and Capital of 23 September 1996, effective 1 January 1998 (replacing 1989 Convention), concluded between Denmark, the Faroe Islands, Finland, Iceland, Norway and Sweden.



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to common themes.<sup>155</sup> While this reflects the general position of the US Treasury and in fact any nation's treaty negotiating body, common themes do exist in the form of the OECD Model and Commentaries as well as the US Model and Technical Explanation. Courts have not limited themselves to references to treaty decisions of the treaty partner: The Federal Court of Appeals in Canada, for example, referred to US court decisions in interpreting the treaty between Canada and China,<sup>156</sup> and invoked a UK decision to interpret a Canada–US treaty.<sup>157</sup>

In another decision, the Canadian Court of Appeals noted with respect to interpreting the Canada–US treaty:

While it is true that this Court has the right to interpret the Canada-United States Tax Convention and Protocol itself, and is in no way bound by the interpretation given to it by the United States Treasury, the result would be unfortunate if it were interpreted differently in the two countries where this would lead to double taxation.<sup>158</sup>

International business appears to transcend even the fundamental legal distinction between “common law” and “civil law” countries. For instance, the New Zealand Tax Court cited a decision of the German Federal Tax Court (*Bundesfinanzhof*) in a case regarding the New Zealand–UK income tax treaty;<sup>159</sup> the US Tax Court,<sup>160</sup> interpreting the US–Japan tax treaty, referred to and adopted the reasoning of a German court decision regarding the Germany–Netherlands treaty.

Where domestic court decisions contain a sound analysis that considers the international context of the treaty language, interpretive results can be of value for the interpretation of other treaties that were concluded adopting the Model Treaty language. While court decisions of one country are certainly not binding on another, they have played and continue to play a crucial role in the formation and further clarification of an international tax treaty system that operates using a common international tax language.

#### 2.4. The case for an international tax language

Prokisch noted that “in case of interpreting tax treaties we must read Article 31(1) as follows: a term must be interpreted in accordance with the ordinary meaning given to it by international tax language.”<sup>161</sup> He defines “international tax language” as “the common international understanding of terms which are used within the formulation of tax treaties.”<sup>162</sup>

The view that tax treaty language is an “international tax language” has been explicitly confirmed by courts in the United Kingdom,<sup>163</sup> India,<sup>164</sup> New Zealand,<sup>165</sup> the Netherlands<sup>166</sup> and South Africa.<sup>167</sup> In *Indofood International Finance Ltd. v. JP Morgan Chase NA, London Branch*,<sup>168</sup> the Dutch court held that the term “beneficial ownership” used in the interest and dividend articles has an “international

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<sup>155</sup> Proceedings of the New York University Fortieth Annual Institute on Federal Taxation (1982).

<sup>156</sup> *Quig Gong Kli v. The Queen*, 94 DTC 6059.

<sup>157</sup> *The Queen v. Bank of Nova Scotia*, 81 DTC 5115.

<sup>158</sup> *Canadian Pacific Ltd. v. The Queen*, 76 DTC 6120, at 6135.

<sup>159</sup> *CIR v. United Dominican Trust*, 197331 NZTC 61-028.

<sup>160</sup> *Taisei Fire and Marine Insurance Co. Ltd. v. Commissioner*, 104 TC 535 (1995).

<sup>161</sup> Prokisch in K. Vogel (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, Series on International Taxation (1998) p. 103 (106). Opp. Pijl, p. 259, at note No. 21: “The interpretation method under which a term is explained as a general concept of ‘international tax language’ is, in the author’s opinion, not sustainable, considering the text of Art. 3(2) of the OECD Model.”

<sup>162</sup> Prokisch, id., at p. 104.

<sup>163</sup> In *Ostime v. Australian Mutual Provident Society*, Lord Radcliffe noted: “The language employed in this agreement is what may be called international tax language and ... such categories as ‘enterprise’, ‘industrial or commercial profits’ and ‘permanent establishment’ have no exact counterpart in the taxing code of the UK.”

<sup>164</sup> See M. Butani, “India – Tax Treaty Interpretation”, *Asia-Pacific Tax Bulletin* 2004, No. 1, pp. 56 et seq. (62).

<sup>165</sup> *Commissioner of Inland Revenue v JFP Energy Incorporated* (1990) 3 NZLR, at 536.

<sup>166</sup> E.g. *Hoge Raad, Beslissingen in belastingzaken Nederlandse Belastingrechtspraak* (BNB), 1991/248.

<sup>167</sup> Regarding the South Africa–Switzerland Income Tax Treaty (1967), see the case *Secretary for Inland Revenue v. L.J. Downing*, Natal Income Tax Special Court, Case No. 6737, decision of 27 October 1972.

<sup>168</sup> Court of Appeal, decision of 2 March 2006, 8 ITR 653 (2006) STC 1195.

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fiscal meaning”. Courts around the world have in principle shown recognition of an international common understanding expressed in tax treaties.<sup>169</sup> This common international consensus has its foundation in the Model Tax Treaties and Commentaries developed by international bodies such as the League of Nations, the OEEC as predecessor to the OECD, and the US Model Treaties.<sup>170</sup>

In a 1957 note by its chairman on the aims of the Fiscal Committee – classified as confidential and intended to be discussed at an ensuing session of the FC – it is stated:

From the very outset, the work of the Committee has been governed by the question whether it would not be possible to find, from the point of view of the demarcation of the individual countries’ taxing powers, a policy acceptable to all O.E.E.C. countries.... This advantage becomes particularly obvious if common definitions are agreed upon.<sup>171</sup> ... The question might be considered of replacing certain clauses in existing conventions for the avoidance of double taxation – for instance definitions – by a uniform text prepared by the Committee, of course only in so far as the Committee’s conclusions were not already taken into account when the conventions were drafted.<sup>172</sup>

This confirms that certain concepts and interpretive conclusions can be presumed as a starting point in interpretation where the contracting parties have adopted the OECD Model texts.

The conjecture of a set of autonomous international concepts in tax treaties already existed when the foundations of today’s tax treaty network were laid. Mitchell B. Carroll, who was a member of the League of Nations Committee that prepared the 1928 Draft Conventions and who later became the first Honorary President of the IFA, appears to be one of the first to note that the terms used in tax treaties are expressed in “international tax language”,<sup>173</sup> thus recognizing that terms used in tax treaties are to be seen autonomously in their international context.<sup>174</sup>

“International tax language” employs open formulations and contains very few definitions. Nevertheless, the conclusion of tax treaties along the lines of the OECD Model Conventions warrants for them to be seen as encapsulating a compromise<sup>175</sup> in the sense of a common international consensus among governments. Although it will in many cases be the “lowest common denominator”,<sup>176</sup> such a common basis can be decisive in cases of uncertainty.

In 1927, Pasquale d’Aroma, the Chairman of the Committee of Technical Experts that prepared the first Draft Conventions under the auspices of the League of Nations, noted:

[H]aving regard to the diversity of the legislative system represented in the Committee, and the necessity for finding formulae capable of acceptance by everyone, it will be recognised that the experts were bound to confine themselves to indicating general rules, leaving particular points of difficulty to be dealt with – in the spirit of the accepted general principles – by those on whom the task of negotiating the bilateral conventions will ultimately fall.<sup>177</sup>

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<sup>169</sup> See further Prokisch, “Does it Make Sense if We Speak of an ‘International Tax Language’?”, in K. Vogel (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, Series on International Taxation (1998) p. 103 (103).

<sup>170</sup> Vogel/Prokisch, General Report p. 62, speaking of an *international fiscal language*, state: “Indeed, the Model Conventions by the League of Nations, the OECD and the United Nations must be considered steps in the development towards such an international language of specified terms.”

<sup>171</sup> OEEC, Fiscal Committee, Note by the Chairman on the aims of the Fiscal Committee, Paris, 23 January 1957, TFD/FC/10, p. 2.

<sup>172</sup> *Id.*, p. 4.

<sup>173</sup> 1935, 588; Carroll, *Global Perspectives of an International Tax Lawyer* (1978).

<sup>174</sup> Similar views are held in Rest pp. 179 et seq. See also Prokisch in K. Vogel (ed.) at p. 104: “International tax language is the common international understanding of terms which are used within the formulation of tax treaties.”

<sup>175</sup> Messere, *European Taxation* 1993, p. 246: “The compromise approach inherent in getting the consensus necessary to reach any agreed model has so far mostly prevailed, but this flexibility causes much uncertainty.” See also Edwardes-Ker, *Tax Treaty Interpretation* (1995) Chap. 7, p. 14: “[Tax treaty definitions] typically follow a model which neither signatory State may have analysed in-depth. They often represent a compromise between two States.”

<sup>176</sup> Cf. the Report submitted by the Technical Experts to the Financial Committee of the League of Nations: “After long discussion, we finally arrived at agreement on certain fundamental points.” (League of Nations Double Taxation and Tax Evasion (1925) Part I, m.no. 3).

<sup>177</sup> League of Nations, Double Taxation and Tax Evasion, Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Covering Letter addressed by the Chairman of the Committee of Technical Experts on Double Taxation and Tax Evasion to the Chairman of the Financial Committee of 12 April 1927.

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Similar language can be found in the subsequent Report containing several drafts for possible Double Tax Conventions:

The Meeting endeavoured to reach complete agreement on all essential points. In view, however, of the diversity of fiscal systems, the differences in national economic interests and the divergent conceptions concerning both theory and practice, unanimous agreement could not be reached in regard to all the questions which had to be dealt with. Points on which complete understanding could not be achieved have been left for decision to any States desiring in the future to negotiate bilateral treaties. The Meeting, however, earnestly strove to reduce to a minimum the number and importance of questions thus left open.

Avi-Yonah has called the current international tax regime “a miracle because taxes are the last topic on which one would expect sovereign nations to reach a consensus.”<sup>178</sup> Moreover, he argues that to the extent that there is *opinio juris* on the part of states complying with international tax rules laid down in treaties, it can be argued that the rule amounts to customary international law which can be used to ascertain the underlying purposes of treaties.<sup>179</sup> While this line of thought has not been explicitly adopted in jurisprudence, courts worldwide have increasingly recognized the existence of an “international tax language”, especially in cases where undefined treaty terms are unknown to the domestic tax system of the state applying the treaty. A poignant statement in this vein has been given by the High Court of Australia with regard to the term “enterprise”: “[A]n expression such as the word ‘enterprise’ may not have an exact counterpart in domestic tax laws, being part of an ‘international tax language’.”<sup>180</sup>

Van den Tempel<sup>181</sup> has argued that the number of definitions in the OECD Model Conventions should be increased to establish international definitions valid across domestic legal systems.<sup>182</sup> It is desirable to alter existing definitions in the Models so as to minimize referral to domestic tax law. In fact, this has been done as regards the term “interest” in Art. 11 of the OECD Model Tax Convention on Income and Capital.<sup>183</sup> However, in terms of including more definitions in the Model Conventions, there is a danger that this might run counter to their objective of facilitating compromise among contracting states. The Models do not aim at providing comprehensive definitions. By the same token, it would be virtually impossible to cover all possible questions of detail that might arise in different nations. This holds true also for tax treaties negotiated bilaterally among contracting states.

Sasseville stated that more precision in tax treaties would hold great dangers, “as taxpayers and courts might logically assume that to the extent treaty negotiators have taken care to address one narrow issue, they were not as concerned by other narrow issues on which the MC is silent.”<sup>184</sup> This is a valid point considering that a deluge of definitions in the Model Conventions would render them difficult to apply.

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<sup>178</sup> Avi-Yonah, *Tex. L. Rev.* 1996, p. 1303.

<sup>179</sup> For examples evidencing customary international law in taxation issues, see Avi-Yonah, *International Tax as International Law*, University of Michigan, available <http://ssrn.com/abstract=516382>.

<sup>180</sup> *Thiel v. Federal Commissioner of Taxation*, decision of 22 August 1990, 21 ATR 531, at 537.

<sup>181</sup> Van den Tempel, *Relief from Double Taxation* (1967) p. 54.

<sup>182</sup> See also the suggestion in H. Vogel, “Aktuelle Fragen bei der Auslegung von Doppelbesteuerungsabkommen”, BB No. 21, p. 1021 (1021). See also Vogel/Prokisch, General Report, p. 55 (84), who argue that “Model Conventions and specific Double Taxation Conventions should increasingly define terms used, and thus contribute to the development of an “international tax language”.

<sup>183</sup> Para. 3 of Art. 11 in the 1963 version of the Model read: “The term ‘interest’ as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises.” In the revised Model of 1977, this was altered to the effect that “interest” is defined autonomously for purposes of the Model: “The term ‘interest’ as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.” See also M. Lang, ÖStZ 1989, No. 1/2, p. 11 (15).

<sup>184</sup> Sasseville, “The Role of Tax Treaties in the 21st Century”, *Bulletin for International Fiscal Documentation* 2002, p. 247.

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One suggestion might be to elaborate on the definitions currently contained in the OECD “Glossary of Tax Terms”,<sup>185</sup> an international tax dictionary drawn upon by tax practitioners and courts alike. At present, a disclaimer made at the outset of the glossary points out: “Explanations on the terms are very condensed and may not be complete. They are not considered to necessarily reflect the official position of the OECD in interpreting international tax terms, for example, in the tax treaty context.”

Definitions by the experts in the OECD Committee on Fiscal Affairs might improve the chances of further approximation of concepts in the various national tax systems.<sup>186</sup> Nevertheless, an elaboration of definitions on the part of the OECD in the sense of an “encyclopaedia” providing official statements as to what the terms in treaties mean would not be a cure-all for conflicts among nations in the interpretation of terms. Although a worldwide approximation of international tax terms would do great service to the attainment of the object and purpose of the OECD Model Conventions, such approximation cannot be achieved through an increase in definitions, no matter how elaborate they may be, as they can never be universally applicable.

Treaty application should strive for an internationally consistent interpretation of terms and use all available materials so as to arrive at an autonomous meaning “from within” the international treaty.<sup>187</sup> Terms in treaties that correspond to the wording of the OECD Model Conventions are to be interpreted against the backdrop of the common international consensus reflected therein, as manifested by international tax language.

Avery Jones rightly noted: “Although the particular treaty being interpreted is a bilateral one, it should be borne in mind that the treaty was not drafted solely with the particular countries’ tax systems in mind when it follows the wording of the Model.”<sup>188</sup>

## **PART II. The structure and workings of Art. 2 of the OECD Model Conventions**

Art. 2 of the OECD Model Conventions provides a system whereby the taxes covered under the treaty are determined. The framework provided in this article is largely adhered to in treaty practice. In the application of tax treaties, the mode to ascertain whether certain payments are within treaty coverage is therefore generally analogous. However, as automated as the adoption and application of this provision seems to be, it does prompt unclear points that have resulted in differences of opinion among contracting parties.

The preliminary remarks to the OECD Model Commentaries on Art. 2<sup>189</sup> give the following broad explanation of the structure of this Article:

The Article is intended:

- to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise;
- to ensure identification of the Contracting States’ taxes covered by the Convention;

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<sup>185</sup> The “Glossary of Tax Terms” has been made available by the OECD at <http://www.oecd.org>.

<sup>186</sup> There is an ongoing academic debate between proponents of global tax harmonization and proponents of unilateral solutions, boiling down to the question whether there might be such a thing as a “world tax regime”, a worldwide single set of international tax rules. For purposes of this treatise, it would lead too far to deal with these issues. See Brauner, “An International Tax Regime in Crystallization”, *Tax L. Rev.* 2003, Vol. 56, p. 259; Rosenbloom, “International Tax Arbitrage and the ‘International Tax System’”, *Tax L. Rev.* 1999, Vol. 53, p. 137.

<sup>187</sup> M. Lang, *Doppelbesteuerungsabkommen und innerstaatliches Recht* (1992) p. 105, arguing that an interpretation using all available materials in connection with the tax treaty to interpret the treaty from “within itself” is unlikely to produce cases where such international meaning cannot be derived.

<sup>188</sup> Avery Jones, “Problems of Categorizing Income for Tax Treaty Purposes”, in van Raad (ed.) *International and Comparative Taxation – Essays in Honour of Klaus Vogel* (2002) p. 9 (18).

<sup>189</sup> OECD, Commentaries on the Articles of the Income and Capital Model Convention of 15 July 2005, Commentary on Art. 2, m.no.1; Commentary on the Estates and Inheritances and on Gifts Model Convention of 3 June 1982, Commentary on Art. 2, point I., m.no. 1.

- to widen as much as possible the field of application of the Convention by including as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities;
- to avoid the necessity of concluding a new Convention whenever the Contracting States' domestic laws are modified; and
- to provide for the periodic exchange of information about changes which have been made in their respective taxation laws.

These formulations originate from the exact same wording contained in the Commentary on a Draft Art. 2 adopted by the OECD Fiscal Committee in 1957<sup>190</sup> and have been used ever since in the official OECD Commentaries to describe the general object and purpose of Art. 2.

Until 1963, when the Draft Conventions of the OECD Fiscal Committee were turned into “full-fledged” Model Conventions, this basic outline of Art. 2 was followed by the statement: “The clauses are framed as simply and comprehensibly as possible and in a similar manner for taxes on income and capital and taxes on estates and inheritances.”<sup>191</sup> This statement is still accurate with respect to the present Model versions of Art. 2.<sup>192</sup>

In the following, closer consideration will be given to the four paragraphs of Art. 2, separately as well as with a view to their interconnectedness. Special attention will be given to the Reports of experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries.

At a session of the OEEC FC in 1956, the agenda was laid down to study, inter alia, “the listing and definition of taxes on income and capital”.<sup>193</sup> This was followed by the institution of WP No. 3, consisting of Delegates from Italy and Switzerland, who submitted, as a result of their studies of the existing tax treaties, a Report containing Draft Conventions (see Annex I) and Commentaries thereto.<sup>194</sup> Following this Report, a Draft Article was adopted by the FC, the formulations of which are virtually identical to those in the 1963 OECD Model Conventions. (Annex I).

In 1967, the OECD Fiscal Committee established WP No. 30<sup>195</sup> and appointed the experts from Austria and Switzerland, inter alia, to analyse existing treaties and deal with difficulties encountered in the application of Art. 2. The considerations in the 1969 Report of WP No. 30<sup>196</sup> shed further light on the texts of the 1963 Model Conventions and Commentaries and served as a guideline in the drafting of the 1977 Income and Capital Model Conventions.

The considerations contained in the above-cited OECD WP Reports have in principle lost none of their actuality with regard to current treaty practice, as Art. 2 has seen no fundamental changes in structure and wording since its 1963 version (cf. Annex I).

<sup>190</sup> FC(57)1, Paris, 17 October 1957, on p. 4.

<sup>191</sup> FC(57)1, p. 4; OEEC, Report of the Fiscal Committee on its Work, FC(68)2 (1st Revision) Part II, Annex A, m.no.2. The texts, in substance, differ only in two aspects: Until 1963, Art. 2 contained a Para. 5 stating: “The competent authorities of the two States shall by mutual agreement clarify any doubts which may arise as to the taxes to which the Convention ought to apply.” This is in line with Para. 3 of Art. 25 (Mutual Agreement) and was thus deleted in the context of Art. 2. The second major difference is that gifts were not included in the Estates and Inheritances MC before they were incorporated in the 1982 MC.

<sup>192</sup> These older versions of Art. 2, in substance, differ only in two aspects: Until 1963, Art. 2 contained a Para. 5 stating: “The competent authorities of the two States shall by mutual agreement clarify any doubts which may arise as to the taxes to which the Convention ought to apply.” This is in line with Para. 3 of Art. 25 (Mutual Agreement) and was thus deleted in the context of Art. 2. The second major difference is that gifts were not included in the Estates and Inheritances MC before they were incorporated in the 1982 MC.

<sup>193</sup> FC/M(56)1(Prov.)3.

<sup>194</sup> OEEC, WP No. 3 of the Fiscal Committee (Italy–Switzerland) on the Listing and Definition of Taxes on Income and Capital (including Taxes on Estates and Inheritances) which should be covered by Double Taxation Agreements, Paris, 10 January 1957, FC/WP 3(57)1.

<sup>195</sup> OECD, Fiscal Committee, Summary record of the 27th Session held at the Château de la Muette, Paris, 2 October, 1967, FC/M(67)2, m.no.1: “The Fiscal Committee set up Working Party No. 30 to examine Articles 2, 3, 6, 13 and 22 of the O.E.C.D. Draft Double Taxation Convention on Income and Capital 1963 in order to complement and improve these Articles and to study problems arising in connection.”

<sup>196</sup> OECD, WP No. 30 of the Fiscal Committee (Austria–Switzerland), Paris, 27 June 1969, FC/WP 30(69)1.

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## 1. The general description in Art. 2(1) and (2)

In both OECD Model Conventions, Art. 2(1) states in a general manner the scope of application of the treaty, namely “taxes on income and on capital” and “taxes on estates, inheritances, and on gifts”.<sup>197</sup> As can be deduced from the wording that the Convention “shall apply to” said taxes, the function of this statement is more than just an introductory headline; it aims to set a general boundary for the cases of double taxation it is designed to prevent. Art. 2(1) is to be read in conjunction with Art. 2(2) since it enlarges on the statement made in paragraph 1.

The OECD Commentaries on Art. 2(2) in both Model Conventions state that this paragraph “gives a definition” of the taxes covered. However, the “definition”<sup>198</sup> of the taxes covered in paragraph 2 bears more resemblance to an observation than a definition: Taxes on income and on capital are described as “all taxes imposed on total income, on total capital, or on elements of income or of capital...” Indeed, a certain tautology<sup>199</sup> can be detected, similar to the circular definition of an elephant stating, “An elephant is large and grey and lives in a herd of elephants.”<sup>200</sup>

The description in Art. 2(2) of the Estates, Inheritances and Gifts MC is slightly more expressive: Taxes on estates and inheritances are described to be “taxes imposed by reason of death in the form of taxes on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on *donationes mortis causa*”, whereas “[t]here shall be regarded as taxes on gifts taxes imposed on transfers *inter vivos* only because such transfers are made for no, or less than full, consideration.” Greater detail of this description in comparison to the description in the Income and Capital MC can be explained by the fact that the area of *donationes mortis causa* and *donationes inter vivos* is per se a special matter as opposed to the broad field of income and capital taxation primarily relied on in most countries.<sup>201</sup>

With respect to Art. 2(1) and (2), the Report of WP No. 30 states:

Both paragraphs together describe in a fundamental and general way, but without going into details, the taxes to which the Convention applies. These taxes are then – provided they are in force at the time of signature of the Convention – enumerated by note in the lists of paragraph 3; the special purpose of this paragraph in its present form is merely to illustrate what was said generally in paragraphs 1 and 2.<sup>202</sup>

The Report also observes that “the general descriptions given in paragraphs 1 and 2 are not too precise and might probably be called to be rather vague.”<sup>203</sup>

Nevertheless, the important role of paragraphs 1 and 2 cannot be overestimated: The adoption of an international treaty entails that common solutions are to be found on the basis of the text that has been agreed upon. By adopting the broad terminology of paragraphs 1 and 2 in their treaty text, the parties have expressed objective intent as to their being bound accordingly, in line with the declared purpose of Art. 2 to “widen as much as possible the field of application of the Convention”. This explains why states will often choose to omit paragraphs 1 and 2 in the text of Art. 2 and limit their scope of agreement to such taxes as are explicitly listed.

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<sup>197</sup> The OECD Commentary to the Income and Capital MC on Art. 2(1) states: “This paragraph defines the scope of application of the Convention: taxes on income and on capital...”. The Commentary to the Estates, Inheritances and Gifts Model provides: “This paragraph establishes the scope of the Convention as to the taxes covered, namely: taxes on estates and inheritances and taxes on gifts.”

<sup>198</sup> The OECD Commentaries on Para. 2 state that this paragraph “gives a definition” of the taxes covered in the respective Model Convention.

<sup>199</sup> Cf. also K. Vogel, speaking of a tautology in his Commentary on Art. 2 para. 2, m.no. 30.

<sup>200</sup> See Williams/Morse, *Davies: Principles of Tax Law* (2004) p. 3; the authors employ this notion to illustrate the difficulty of defining the term “tax”.

<sup>201</sup> The substance of the concept of “taxes on income and capital” and “taxes on estates and inheritances and on gifts” will be dealt with elaborately in Part III of this study. Further elaboration in this vein does not serve the present purpose of evaluating the functional framework provided in Art. 2.

<sup>202</sup> FC/WP 30(69)1, p. 5, m.no. 7.

<sup>203</sup> *Id.*, m.no. 9.

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## 2. The list of taxes in Art. 2(3)

The idea of a blank list to be filled in by the contracting states as to their respective taxes covered under the treaty has taken centre stage in Model Tax Conventions ever since the very first Drafts of the League of Nations. The regular text of the OECD Income and Capital MC provides for an enumeration of taxes that is merely of illustrative character, as clearly indicated by the phrase “in particular”. The listing in the Estates, Inheritances and Gifts MC, on the other hand, is exhaustive. This could be explained by the fact that the field of taxes on estates, inheritances or gifts is much more contained, whereas taxes in the area of income and capital existing in a given state will regularly be numerous; in particular, taxes on income have in many states functioned as an “engine of the revenue”<sup>204</sup> and have taken numerous forms and variations.

The wording “in particular”, indicating that the list is not exhaustive, can be found in treaties in the area of income and capital as early as 1925.<sup>205</sup> Looking to the roots of tax treaty practice (cf. Annex II), the inconsistency with respect to exhaustive or non-exhaustive listings becomes obvious and it is equally prevalent in the current tax treaty network. Earlier treaties sometimes coupled a general description of the taxes covered with an express provision for agreement of the contracting states as to the taxes covered. US and UK treaties have had a close connection to the League of Nations Drafts<sup>206</sup> and thus regularly provide for an exhaustive listing of the taxes covered.

The Commentary on Art. 2(3) states: “The list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the Convention.”<sup>207</sup> As Lang has pointed out,<sup>208</sup> the statement seems to a certain extent contradictory: On the one hand, the list is expressly said not to be complete but, on the other hand, it should “in principle” be seen to be exhaustive.

The roots of this formulation in the Commentary can be traced back to the work of WP No. 3 of the OEEC Fiscal Committee. The Italian Delegate noted in his Commentary:

The object of the list provided for in the third paragraph of the draft is clear. Such a list gives the Contracting States and each taxpayer an accurate idea of the field of application of the Convention. The Italian Delegate considers that the list provided should not be irrevocable but should merely serve to illustrate the preceding paragraphs of the draft. However, in view of the high qualifications and experience of the persons whose duty it is to conduct the preliminary discussions for a Convention, it is safe to say that in practice the lists are complete and authoritative for the interpretation and application of the Conventions.<sup>209</sup>

The Swiss Delegate, with respect to the identical text in Para. 4 of his Draft (cf. Annex I), is less wordy: “Paragraph 4 lists the taxes imposed by each of the two States at the time of signature of the Convention.” The Commentary to the Draft eventually adopted by the Council (cf. Annex I) supports the explanations of the Italian Delegate in stating as follows:

Paragraph 3 lists the taxes in force at the time of signature of the Convention. The list is not exhaustive. It serves to illustrate the preceding paragraphs of this Article. In principle, however, it will be a full list of the taxes imposed in each State at the time of signature and covered by the Convention.<sup>210</sup>

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<sup>204</sup> Plehn, “Review of *The Income Tax. A Study of the History, Theory, and Practice of Income Taxation at Home and Abroad* by Edwin R.A. Seligman”, *Am. Ec. Rev.* 1915, Vol. 5, No. 1, p. 115.

<sup>205</sup> See, e.g., Art. 1 of the 1925 Direct Taxes Convention and Final Protocol between Italy and the German Reich, (published 31 October 1925; effective 1 January 1926).

<sup>206</sup> Flick, “Zur Auslegung von Normen des Internationalen Steuerrechts“, in Felix (ed.) *Von der Auslegung und Anwendung der Steuergesetze* (1958) p. 160.

<sup>207</sup> Para. 6 of the Income and Capital MC Commentary.

<sup>208</sup> M. Lang, “Taxes Covered – What is a ‘Tax’ according to Art. 2 OECD Model Convention?”, *Bulletin for International Fiscal Documentation* 2005, p. 220.

<sup>209</sup> FC/WP 3(57)1, Commentary by the Italian Delegate, under Point C., at m.no. 6.

<sup>210</sup> OEEC, Fiscal Committee, Listing and Definition of Taxes on Income and Capital, Including Taxes on Estates and Inheritances, which should be covered by Double Taxation Agreements, Paris, 17 October 1957, FC(57)1, Commentary on the Draft Art., Point II., m.no. 9.

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The non-exhaustive listing obviously accounts for an assumption on the part of the contracting parties that despite their respective “high qualifications and experience”, they may forget to enumerate certain taxes, due to the fact that there will regularly be a broad field of taxes in the area of income and capital in the various states. This is confirmed by WP No. 30, which sees problems in an exclusive listing in that “[a] wrong decision about the character of a tax or ‘forgetting’ a surcharge would mean that those levies were not within the scope of the Convention, even if later on both Contracting Parties admitted that the tax in question should have been enumerated in the list.”<sup>211</sup>

Lang argued that such forgetfulness can plausibly be presumed only with regard to taxes that are not major revenue-raising taxes of the respective state, because treaty negotiators can be deemed to be extremely careful to include such major taxes.<sup>212</sup> Büge makes this argument with respect to taxes that have had a firm and substantially stable place in the taxation system of the state.<sup>213</sup> This assumption, although it will regularly be true in practice, is not generally supported by WP No. 30:

The list of taxes will also give in principle a complete picture of all taxes imposed in each State at the time of signature and covered by the Convention. However, taxes not enumerated in paragraph 3 but qualifying for a test under paragraphs 1 and 2 are – under the present O.E.C.D. concept – nevertheless within the scope of the Convention.

Thus, if the parties incorporate broad general descriptions in the sense of Art. 2(1) and (2), coupled with a merely illustrative list of taxes covered, the objective intent can be seen to be of the character to “broaden as much as possible the scope of the Convention.” Although it is highly unlikely in practice (“in principle ... it will be a complete list”), it is not generally ruled out that even major taxes on income and capital that are not mentioned in the non-exhaustive list may still come within the substantive scope of the treaty. In case of a dispute, unless it is established that the tax at issue was omitted purposely, the presumption should be that a tax omitted in the illustrative listing of Art. 2(3) will nevertheless be covered if it comes under the general descriptions of Art. 2(1) and (2). This approach best serves the purpose of Art. 2 to clarify the scope of the Convention: Exclusions of a tax from the intended broad scope should be explicitly made cognizable by the contracting parties.

Apart from ensuring, in connection with Art. 2(1) and (2), a broad scope of the treaty, the non-exhaustive nature of paragraph 3 could also be seen to serve another function: Lang<sup>214</sup> makes the point that treaty negotiations usually span a considerable period of time, involving several rounds of negotiations; this makes it difficult, in the event of changes in the tax law of each of the contracting states, to go back to issues that have already been discussed. Art. 2(3) could thus take account of events such as the introduction of a new tax in one or both of the states before the finalization of negotiations and signing of the treaty. There is no hint in the materials backing that this was, in fact, a consideration in the drafting of the Model text. The words “conclusion” and “signature” are used interchangeably throughout the materials, as well as in the current Commentaries. Still, whether this was intended or not, the non-exhaustive list will undeniably have this effect, which serves practicability in treaty negotiations and will generally be in the interest of the contracting parties. This is in line with the finding that the demonstrative listing was instituted to diminish cases of mutual consultation of the parties in unclear cases as to the taxes covered.

### **3. Art. 2(3) relating to Paras. 1 and 2**

The general description of the taxes covered, alongside a list of taxes covered given by each of the contracting states, raises questions as to how these paragraphs are interrelated. The inclusion of a general description does not always go hand in hand with the adoption of a merely illustrative listing; for instance, the Estates, Inheritances and Gifts MC includes a general description despite the fact that

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<sup>211</sup> FC/WP 30(69)1, m.no. 11.

<sup>212</sup> M. Lang, “Taxes Covered”, p. 220.

<sup>213</sup> Büge in Becker/Höppner et al. (eds.), “Commentary on Art. 2(3)”, m.no. 35.

<sup>214</sup> M. Lang, “Taxes Covered”, p. 220.



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the list therein is of exclusive nature. Similarly, the 2006 US Model contains an exhaustive listing coupled with a general description.<sup>215</sup>

Baker has stated that paras. 1 and 2 have no stand-alone significance within the structure of Art. 2.<sup>216</sup> Wassermeyer has argued that the list in para. 3 restrains the general descriptions in paras. 1 and 2, as it will in general be a complete listing.<sup>217</sup>

This, however, begs the question why the abstract definitions do feature in the current Model texts. In conformity with the customary legal principle *ut res magis valeat quam pereat*,<sup>218</sup> as well as with a view to the object and purpose of Art. 2 to “widen as much as possible the field of application of the Convention”, it cannot be assumed that paras. 1 and 2 are without substance.<sup>219</sup>

The non-exhaustive list in Art. 2(3) cannot thus restrict the scope laid out in the wording of paras. 1 and 2. If the parties have incorporated a general description equivalent to paras. 1 and 2, it will not suffice to look to para. 3 to determine the taxes covered. The parties can be held to their express consent on such broad coverage as expressed in the general description. If they wish to limit their commitment, they are free to do so, as is specifically recognized in the Income and Capital MC Commentary:

Some Member countries do not include paragraphs 1 and 2 in their bilateral conventions. These countries prefer simply to list exhaustively the taxes in each country to which the Convention will apply, and clarify that the Convention will also apply to subsequent taxes that are similar to those listed.

Countries that wish to follow this approach might use the following wording:

‘1. The taxes to which the Convention shall apply are:

- a) (in State A): .....
- b) (in State B): .....,<sup>220</sup>

With respect to the importance of paras. 1 and 2, WP No. 30 states:

The omission of paragraphs 1 and 2 would primarily affect the position of paragraph 3: under the present scheme, the ‘ultimate responsibility’ for the determination of the subject of the Convention goes with paragraphs 1 and 2; ... [L]eaving out paragraphs 1 and 2 would mean that the scope of the Convention is determined solely by the list of taxes in paragraph 3; and this would imply that the enumeration of taxes therein must be *exhaustive*....<sup>221</sup>

This supports the view that paras. 1 and 2 play an independent role in the determination of taxes covered. It also indicates that Art. 2(4) (analysed in more detail below) plays an equally important role irrespective of whether the list in Art. 2(3) is exhaustive or merely demonstrative.

On its face, omitting paras. 1 and 2 and adopting an exhaustive listing seems to facilitate treaty application. There are, however, serious pitfalls to this decision.

WP No. 30 elaborates:

If paragraphs 1 and 2 were omitted and the list of taxes was made exhaustive,... the scope of the Convention – at least as far as the ‘existing taxes’ are concerned – would then be described in a most precise form. But it should be borne in mind that the importance of an exhaustive list which determines for itself the subject of the Convention goes far beyond that of a list which serves only as illustration for a general formula. The elaboration of an exhaustive list would therefore cause much more problems and difficulties than the compilation of a list of the present paragraph 3.

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<sup>215</sup> See further *infra* in this chapter.

<sup>216</sup> Baker, Commentary, 2B.04: “Of themselves, these two paragraphs are of limited practical significance, but they are relevant when determining what constitute ‘identical or substantially similar’ taxes under paragraph (4).”

<sup>217</sup> Wassermeyer in Debatin/Wassermeyer, *Doppelbesteuerung* (2004) Commentary on Art. 2, m.no. 11.

<sup>218</sup> This principle, also called “principle of effectiveness”, was recognized by the ICJ in the 1966 YBILC, Vol. II, p. 219: “When a treaty is open to two interpretations one of which does and the other does not enable the treaty to have appropriate effects, good faith and the objects and purposes of the treaty demand that the former interpretation should be adopted.”

<sup>219</sup> See also the argument to this effect in Sutter, “Der sachliche Anwendungsbereich des ErbSt-MA“, in Aigner et al. (eds.) *Erbschaftssteuer und Doppelbesteuerungsabkommen* (2002) p. 62.

<sup>220</sup> Point 6.1. of the Income and Capital MC Commentary to Para. 3 of Art. 2.

<sup>221</sup> FC/WP 30(69)1, m.nos. 7 and 9 (emphasis in the original text).

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It would not be sufficient for the Contracting Parties to agree only on the principle that all taxes on income (capital) within the meaning of the general definition of paragraphs 1 and 2 should be covered by the Convention, but each Contracting Party would be obliged to scrutinize most carefully every single tax, accessory duty, charge, contribution and any other levy of any form of both Contracting States to find out whether such tax should be mentioned in the list.<sup>222</sup>

In accordance with the objective intent expressed by the incorporation of general descriptions in the sense of paras. 1 and 2, these paragraphs should be seen to have importance in their own right, independently of the list in para. 3. Whether the tax at issue qualifies as a “tax on income and capital” under the treaty is to be determined also, but not exclusively, with a view to the illustrative listing the parties have provided. To prevent the broad coverage provided in paras. 1 and 2, the parties are free to lessen the substantive scope of their treaty – either by forgoing certain elements of the broad description of paras. 1 and 2,<sup>223</sup> or by restricting the substantive scope to specifically enumerated taxes. In this respect, paras. 1 and 2 can be seen to preserve the broad scope of the Convention.

One could make the argument that paras. 1 and 2 can also have a “restricting” function with respect to the enumerated taxes in para. 3. With respect to the exhaustive list in the Estates and Inheritances Model, Sutter argued that paras. 1 and 2 should be seen to “control” the exhaustive list in para. 3 in the sense that a tax listed in para. 3 that does not come under the general definitions should be seen to fall outside the scope of the treaty. He considers this necessary to prevent “excessive” amplification of the scope of the treaty.<sup>224</sup>

To generally take such a view, however, would disregard the expressed consensus of the contracting parties. If the parties have agreed to list a certain tax, anyone applying the treaty has good reason to believe that this tax is covered, even if the general descriptions were not altered to this effect.<sup>225</sup> This is expressly confirmed in the considerations of WP No. 30:

The Working Party is aware of the fact that there might exist fiscal charges, fees or other levies with respect to which it could be doubtful whether they are ‘taxes on income (capital)’ within the meaning of the general definition given in paragraphs 1 and 2.... If those levies shall be brought under the Convention then it is – in the opinion of the Working Party – sufficient to enumerate such taxes by name in the list of taxes in paragraph 3. Paragraph 3 has quite obviously the power (although being principally an illustration to paragraphs 1 and 2) to amplify the scope of the Convention so that taxes and charges might be included in the Convention even if they were not considered to be ‘taxes on income (capital)’ within the meaning of paragraphs 1 and 2.<sup>226</sup>

This result corresponds to the object and purpose of Art. 2 to provide for broad coverage. “Excessive” broadening in the sense that a treaty partner includes, in its domestic provisions regulating an enumerated tax, elements that are out of character with what the other partner could assume to be comprised in this tax, can be avoided only in accurately determining the objective intent of the parties. In the case of a non-exhaustive enumeration, there is a general presumption that the parties intended to retain broad coverage.

Conversely, the mere exclusion of a tax from the list in Art. 2(3), be it exhaustive or demonstrative, cannot override the general description in paras. 1 and 2. WP 30 states:

If ... the Contracting States want to exclude in their bilateral negotiations certain taxes or charges which are or might probably be ‘taxes on income (capital)’ within the meaning of paragraphs 1 and 2, then it is – in the opinion of the Working Party – not sufficient to exclude such taxes or charges solely from the list of taxes in paragraph 3, but it is necessary to make express reference in the Article that those taxes and charges are excluded from the scope of the Convention. Only if the list of taxes in paragraph 3 was exhaustive, an exclusion of those taxes or charges from such list would for itself be sufficient.<sup>227</sup>

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<sup>222</sup> Id., m.no. 11.

<sup>223</sup> States frequently limit the scope of application to “taxes on income” by deleting the reference to “taxes on capital” in Paras. 1 and 2.

<sup>224</sup> Sutter, *Der sachliche Anwendungsbereich* (2004) p. 64.

<sup>225</sup> M. Lang, *Bulletin for International Fiscal Documentation* (2005) p. 221.

<sup>226</sup> FC/WP 30(69)1, m.no.40.

<sup>227</sup> Id., m.no. 41.

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This appears to reaffirm the statement made at the outset of the Report to the effect that “taxes *not* enumerated in paragraph 3 but qualifying for a test under paragraphs 1 and 2 are – under the present O.E.C.D. concept – nevertheless within the scope of the Convention.”<sup>228</sup> The statement clarifies that in the overall spirit of Art. 2, broad coverage under paras. 1 and 2 applies unless the parties have explicitly provided otherwise. If, for example, neither of the contracting states has mentioned a tax on capital in the list of para. 3, but the general description nevertheless mentions taxes on capital, such taxes will be seen to be covered under the treaty.

If, however, the parties have explicitly stated in either para. 3 or paras. 1 and 2 that a certain tax is outside the scope of the treaty, this expression of consensus must prevail – as in the case where an “atypical” tax is explicitly listed in para. 3 or where the general description notes the exclusion of a certain type of levy. An illustrative example of the extent to which the parties will sometimes specify the substantive scope can be found in the 1994 Sweden–US Treaty.<sup>229</sup> Art. 2 of this treaty provides:

The existing taxes to which this Convention shall apply are: (a) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax and social security taxes) and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. The Convention shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which exempts these taxes....

The development of the US Model Income Tax Convention is interesting in this context. While the 1981 US Model text did not include a general description of taxes covered, the new US Model Income Tax Convention of 15 November 2006 tracks the formulations of paras. 1 and 2 of the OECD Model.<sup>230</sup> The Technical Explanation to the new Model states:

Paragraph 1 identifies the category of taxes to which the Convention applies. Paragraph 1 is based on the OECD Model and defines the scope of application of the Convention.... Paragraph 2 also is based on the OECD Model and provides a definition of taxes on income and on capital gains.<sup>231</sup>

The list of taxes in the US Model, however, is exhaustive. A question arising in this context is whether the general descriptions incorporated alongside an exhaustive listing are intended by the contracting parties to provide a baseline standard with respect to the substantive scope that can in unclear cases have controlling influence over the taxes exhaustively named in para. 3. The Report of WP No. 30 names the example of France:

The O.E.C.D. Analysis of recent Conventions shows further that in 3 Conventions concluded by France ... the list of taxes is exhaustive although those Conventions *have adopted a general description* of the taxes covered by the Convention. This implies obviously that the general description of taxes covered is of importance only with respect to ‘subsequent’ taxes ... but of no importance with respect to the ‘existing’ taxes.<sup>232</sup>

This suggests that the role of paras. 1 and 2 within the structural system of Art. 2 is such that, where the list in para. 3 is of a non-exhaustive character, the range of existing taxes covered under the Convention is as broad as described in paras. 1 and 2. The verbalization of general descriptions is inherently intended to complement the illustrative listing and serve the overall purpose of Art. 2 to

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<sup>228</sup> FC/WP 30(69)1, m.no. 9.

<sup>229</sup> Art. 2 of this treaty provides: “The existing taxes to which this Convention shall apply are: (a) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax and social security taxes) and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. The Convention shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which exempts these taxes....”

<sup>230</sup> Paras. 1 and 2 provide as follows: “1. This Convention shall apply to taxes on income imposed on behalf of a Contracting State irrespective of the manner in which they are levied. 2. There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property.” For more on the provisions in the new US Model, see Avi-Yonah/Tittle, “The New United States Model Income Tax Convention”, *Bulletin for International Taxation* 2007, p. 224.

<sup>231</sup> US Model Technical Explanation accompanying the US Model Income Tax Convention of 15 November 2006, resp. first sentences of the Commentary on Paras. 1 and 2 of Art. 2.

<sup>232</sup> FC/WP 30(69)1, m.no. 38 (emphasis in the original).

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broaden as much as possible the scope of the Convention. In cases where the parties have chosen to make the list of taxes exhaustive, objective intent is expressed to not rely on the vague descriptions in paras. 1 and 2. However, this does not diminish the general guidance provided by the conceptual elements contained in the description.

Irrespective of whether the list is exhaustive or non-exhaustive, the broad formulations in paras. 1 and 2 are not intended to “control” or restrict the scope of the treaty in the sense of preventing “excessive extension” of the substantive scope; in fact, due to their imprecision, they are inherently unsuited to fulfil such a task. Sutter’s argument<sup>233</sup> to the latter effect cannot be upheld in this respect. In the case of an exhaustive list, omitting a certain tax will mean that it is not covered under the treaty; in the case of an illustrative listing, on the other hand, clarification as to the exclusion of a certain existing tax must logically involve paras. 1 and 2, as they are to be relied on, in their broadness, in determining the scope of the treaty. Any tax that can be classified as a “tax on income and capital” will be covered in the case of an illustrative listing. An exhaustive listing specifies the broad language in paras. 1 and 2 to the effect that not any such tax existing at the time of signature will be covered. This specification carries over into the determination of substantial similarity of subsequently imposed taxes under Art. 2(4).

#### 4. The relation between Para. 3 and Para. 4

Both para. 3 and para. 4 incorporate a temporal factor. Para. 3 relates to the taxes existing at the time of signature of the treaty, which will be enumerated either exhaustively or by way of illustration, while para. 4 extends the scope of the treaty beyond the time of its signature.

Explicit mention of the “date of signature” has sometimes appeared in the texts of earlier Draft Model Conventions (see Annex I). Until 1977, however, the OECD Model Convention spoke of “any identical or substantially similar taxes which are *subsequently* imposed in addition to, or in place of, the existing taxes”. No referral was made in the treaty text or the Commentary to the date of signature as the relevant temporal dividing line between paras. 3 and 4.

This prompted calls among OECD Member countries for specification of the term “subsequently”. The 1969 Report of WP No. 30 dealt with this issue in the following clarifying manner:

Reading through the whole of Article 2 shows that the term ‘subsequently’, as used in paragraph 4, has a sort of counterpart in paragraph 3, i.e. ‘existing’. *Both* terms require a reference to a certain time. The O.E.C.D. Commentary on paragraph 3 of Article 2 states that this paragraph ‘lists the taxes in force at the time of signature of the Convention’. Thereby the Commentary makes clear that the term ‘existing’ is related to the *time of signature* of the Convention. This being so, the context between paragraph 3 and paragraph 4 leaves no doubt that the term ‘subsequently’ must necessarily refer to all taxes entering into force after that date, i.e. *after the time of signature of the Convention*.<sup>234</sup>

The amendments made in the 1977 Commentary basically follow a proposal by the Delegate of the United Kingdom: “The United Kingdom feels that the reference in paragraph 4 to ‘taxes which are subsequently imposed’ is not very precise and therefore proposes to use a wording like ‘taxes which are imposed by either Contracting State after the date of signature of this Convention’.”<sup>235</sup>

As was argued in the foregoing, para. 4 ties in with para. 3 in that both paragraphs speak of the “existing” taxes, i.e. the taxes that are covered at the date of signature of the treaty. Notably, para. 4 is indiscriminate as to whether the list in para. 3 is exhaustive or non-exhaustive. The “existing taxes” to which the criteria of substantial similarity should be applied are those contained in either an exhaustive or demonstrative listing in para. 3. Interestingly, the OECD Income and Capital Model Commentary states with respect to Art. 2(4) that this paragraph confirms the non-exhaustive character

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<sup>233</sup> See Sutter in Aigner et al. (eds.) *Erbschaftssteuern und Doppelbesteuerungsabkommen*, p. 64.

<sup>234</sup> FC/WP 30(69)1, m.nos. 43-45 (emphasis in the original).

<sup>235</sup> Id., m.no. 42.

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of para. 3:<sup>236</sup> “This paragraph provides, *since the list of taxes in paragraph 3 is purely declaratory*, that the Convention is also to apply to all identical or substantially similar taxes.”<sup>237</sup>

This is misleading in that it seems to imply that the provision of Art. 2(4) is not necessary where the list of taxes covered is exhaustive. This is clearly not the case, as para. 4 is intended to prevent renegotiation of the treaty whenever there are changes in internal law. The Commentary to the Estates, Inheritances and Gifts MC, which contains an exhaustive list of taxes covered, states with respect to Art. 2(4):

This paragraph provides that the Convention is also to apply to all identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. This provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its taxation laws.<sup>238</sup>

In fact, in the case of an exhaustive listing, the importance of providing for flexibility via paragraph 4 is especially crucial. The independent significance of the general descriptions in paras. 1 and 2 becomes apparent: A tax will be covered under the treaty so long as it qualifies as a “tax on income and capital” in the sense of the general descriptions.

## 5. Automatic extension to “substantially similar” taxes in Art. 2(4)

Art. 2(4) provides that “any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes” will automatically be included. This is a characteristic provision which has featured in tax treaties since the very beginnings of bilateral tax treaty conclusion (cf. Annexes I and II).

Vogel described the role of paragraph 4 most concisely, stating that the provision “takes into account the fact that the treaty text can expressly name only such taxes as exist at the time when the treaty is being concluded.”<sup>239</sup> Art. 2(4) preserves treaty benefits in case of changes perceived to be immaterial to the bilateral consensus when the treaty was signed. From the point of view of international law, this provision is extraordinary, as it expresses a general commitment of the parties also with regard to future events. The Report of WP No. 3 expressly calls attention to the fact that with “Conventions without any mention of future taxes”, there is “the disadvantage that, in the event of the introduction of new arrangements or of changes in the tax structure in the two States, the Convention will become obsolete and the two contracting parties will be obliged to negotiate new agreements.”<sup>240</sup>

The general statement in the Model Commentaries that Art. 2(4) “is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its taxation laws”<sup>241</sup> addresses the fact that the field of taxation in the various countries is typically highly dynamic and frequent changes in tax law provisions are to be expected. This is especially true for taxes on income and capital in the various states.<sup>242</sup> The inclusion of a clause like paragraph 4 avoids the treaty having to be amended in the case of minor changes in the respective domestic tax systems of the parties.

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<sup>236</sup> See also Wassermeyer in Debatin/Wassermeyer, Commentary on Art. 2 para. 4, m.no. 66: “[The extension in Para. 4] confirms that the list of taxes does not contain an exhaustive enumeration.” Translation from German by author of this thesis.

<sup>237</sup> Income and Capital MC Commentary on Art. 2 para. 4, m.no. 7 (emphasis added).

<sup>238</sup> Estates, Inheritances and Gifts MC Commentary on Art. 2 para. 4, m.no. 9.

<sup>239</sup> K. Vogel, Commentary on Art. 2 para.4 , m.no. 52. See the similar statement of Sutter regarding Art. 2(4) of the Estates, Inheritances and Gifts MC: Sutter in Aigner et al. (eds.) *Erbschaftssteuern und Doppelbesteuerungsabkommen* (2002) p. 60.

<sup>240</sup> FC/WP 3(57)2 of 2 May 1957, II.A., m.no. 4.

<sup>241</sup> 1977 Income and Capital MC Commentary on Art. 2 para. 4, m.no. 7; 1982 Estates, Inheritances and Gifts MC Commentary on Art. 2 para. 4, m.no. 9.

<sup>242</sup> Cf. the Draft Conventions of Mexico and London (Annex I) of 1943 and 1946, resp., which did not include a provision bearing analogy to Para. 4.

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Neither the Model Conventions nor the Commentaries specify by what parameters taxes may be classified to be “identical or substantially similar”. *Webster’s Third New International Dictionary* defines “similar” as “having characteristics in common” and being “alike in substance or essentials”. The Draft Conventions of Mexico and London (see Annex I) speak of taxes “upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.” Apart from this automatic extension, the London Draft specifies in Art. XIX that “in the event of substantial changes in the tax laws of either of the Contracting states, the competent authorities of the two Contracting states shall confer together and take the measures required in accordance with the spirit of the present Convention.”

Subsequently, and until the adoption of the 1963 Model texts, the last paragraph of Art. 2 contained an explicit reference to the procedure for mutual consultation of the parties (see Annex I). The Commentary to para. 5 of the 1958 Draft Art. 2 states that this paragraph

is drafted fairly widely to enable the states to consult together whenever they think fit. Normally such procedure may be initiated whenever doubt arises as to the field of application of the Convention in regard to taxes. Doubts may also arise as to the interpretation of one or other<sup>243</sup> of the preceding paragraphs of the Article, in particular paragraph 2, or any other question concerning taxes imposed additionally or substituted.<sup>244</sup>

From the original reference to mutual consultation, it is clear that the contracting states are to confer on the grounds of basic common parameters with respect to both law and fact. The term “substantially similar” should be broadly construed in favour of coverage. Taxes that are factually similar or based on the same or similar objectives are generally intended to come within treaty scope under Art. 2(4).

Similarly to the Mexico and London Drafts speaking of taxes that have “substantially the same bases”, the Italian expert in WP No. 3 (see para. 1 of the 1957 Draft Art. in Annex I) held that “taxes as defined above comprise not only those in force on the conclusion of the Convention, but also all other *taxes of the same character and with the same objects* which are imposed subsequently.”<sup>245</sup>

In a later Report, WP No. 3 presents its analysis of the then existing treaty network and notes that the mere reference in many treaties to “future taxes” or to “new taxes, or taxes replacing those to which the Convention applies” leads to uncertainty in practice, which is why it is proposed that express mention should be made of the “substantially similar character” of future taxes.<sup>246</sup> The Draft that was subsequently adopted<sup>247</sup> (see Annex I) shows a close resemblance to the text of the 1963 Model Conventions.

It is clear from the origins of Art. 2(4) and insinuated in the very wording “*substantially* similar” that the *substance* of the tax is of the essence. The denomination and formal arrangement of the tax cannot be more than a starting point in the determination of its substantial similarity; otherwise, a state could circumvent the test of substantial similarity simply by inserting a newly created tax into the corpus of a tax that is expressly listed in paragraph 3.<sup>248</sup>

Not one characteristic, but several essential incidents of a tax will have to be evaluated to see if it meets the characteristics of a tax enumerated in Art. 2(3).<sup>249</sup>

Vogel noted:

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<sup>243</sup> Sic.

<sup>244</sup> OEEC, Council, Report of the Fiscal Committee on its Activities, Part II, Annex A: Commentary on the Draft Article on Taxes which should be covered by Double Taxation Conventions, C(58)118, m.no. 12.

<sup>245</sup> FC/WP 3(57)1 of 1 January 1957, m.no. 4(e).

<sup>246</sup> FC/WP 3(57)1 of 2 May 1957, point II.A, m.nos. 1 and 2.

<sup>247</sup> FC/WP 3(57)1 of 17 December 1957.

<sup>248</sup> See the argument made by M. Lang in *liber amicorum Helmut Loukota* (2005) p. 282.

<sup>249</sup> See also the Commentaries on Art. 2(4) in Wassermeyer in *Debatin/Wassermeyer*, m.no. 70; K. Vogel, m.no. 53b; Büge in *Becker et al. (eds.)* m.no. 41.

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What is necessary is a comprehensive comparison of the tax laws' constituent elements. In such a comparison, the new tax under review, rather than being compared merely with a solitary older one (to which it will always be similar in some respects and different in others), should be considered with reference to all types of taxes historically developed within the State in question – and of States with related legal systems – in order to determine which of such traditional taxes comes closest to the new tax law.... Whether a tax is 'substantially similar' to another can, consequently, not be decided otherwise than against the background of the entire tax system.<sup>250</sup>

The substance of the taxable object is the ultimate yardstick to measure substantial similarity.

It is expedient to focus on the legal aspects of the tax as the primary standard by which identity or similarity are measured, because economic and political constellations frequently change within a country, which causes factors like tax rates and the effects of a tax to be subject to variation. The key constitutive elements of a tax will regularly lie with the taxable object in the broad sense of the nature of the thing, transaction or sum of money that is subject to tax, and in a narrower sense, what items are included or excluded in the assessment of the tax.<sup>251</sup>

Art. 2(4) clearly ties in with paragraph 3 in that the character of the taxes listed in para. 3 is the benchmark against which the "similarity" in characteristics is gauged. In determining coverage of a tax imposed after the conclusion of the treaty by one of the contracting states, the question arises whether this state can be held also to the characteristics of taxes listed by the other contracting party. No conclusive answer is given in either the Model Commentaries or the materials leading to the formulation of the Commentaries.

The Report of WP No. 30 notes that this question may arise between the parties if no general description corresponding to paras. 1 and 2 is adopted: the WP gives the example of States A and B concluding a treaty that lacks a general description of the taxes covered and enumerates, on the part of State A, taxes on income as well as on capital, whilst on the part of State B, only taxes on income are listed. Assuming that State B subsequently introduces a tax on capital, the Report goes on to state:

The Working Party is aware of the fact that State A has an argument for including the new capital tax in the scope of the Convention which is at least as strong as the argument of State B for excluding the tax: State A might counter that one must not look exclusively to the list of only one State but [that] it is necessary to take into consideration both lists together as one single unit; since State A has embodied his<sup>252</sup> capital taxes in the list also State B's subsequently imposed capital tax falls under the Convention. Whichever might be the solution of this dispute, it is felt that the adoption of provisions like the present paragraphs 1 and 2 would have made such dispute obsolete.<sup>253</sup>

Further into the Report, WP No. 30 implicitly favours an evaluation of both lists seen together in determining the scope of the treaty. Dealing with the question whether the unilateral inclusion of taxes on capital has an influence on developments in the other state, which lists only taxes on income, it is stated:

[T]he Working Party is inclined to refer primarily to paragraph 1 of the O.E.C.D. Commentary on Article 2, stating that the Article intends to widen as much as possible the field of application of the Convention. Based on this fundamental idea of the O.E.C.D. Model Convention, a unilateral inclusion of taxes on capital seems quite preferable.<sup>254</sup>

Subsequently, the WP explains its inconclusiveness in the matter:

Although there could certainly be found more arguments in favour of a unilateral inclusion of taxes on capital, the fact remains undeniable, that the one State who includes unilaterally his capital taxes gives up unilaterally taxation rights too; a situation which might probably be compensated by income tax renunciations of the other Contracting

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<sup>250</sup> K. Vogel, *Double Taxation Conventions*, 3rd edn. (1998).

<sup>251</sup> Cf. the definition of "taxable base" in Larkins (ed.) *International Tax Glossary* (1001), as well as the descriptions of "tax object" and "tax base" in Obenaus/Weidacher, *Handbook of Business English – Keywords in Context* (1990).

<sup>252</sup> Sic.

<sup>253</sup> FC/WP 30(69)1, m.no. 13.

<sup>254</sup> FC/WP 30(69)1, m.no. 34.

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State (such ‘compensation’ could incidentally be caused solely by a higher income tax level in the State with no capital taxes or by his<sup>255</sup> position as ‘debtor state’, etc.). Because of this multiplicity of facts to be taken into account, the Working Party feels that it should be left open for bilateral negotiations between the Contracting States concerned to find a satisfactory solution to this question.<sup>256</sup>

Nevertheless, from the perspective of the object and purpose of Art. 2 as well as from its wording and structure, the stronger argument in case of dispute will be that of State A in the original example: Para. 4 speaks of the “existing taxes”, which spans all of para. 3, i.e. the lists of both states taken together.<sup>257</sup> The agreement entered into between the two parties is made against the background of both tax systems. It lies in the nature of mutual bargaining, which is a vital element in treaty negotiations, to look to the taxes envisaged for coverage by the other contracting party. It can be presumed that not only an identical, but also a similar tax levied in the other contracting state will regularly induce the treaty negotiators to include the tax within the scope of the treaty.<sup>258</sup> Unless the parties have provided otherwise in the treaty or in a Protocol thereto, this “bilateral spirit” should be seen to govern the evaluation of para. 3 in the context of determining identity or substantial similarity under Art. 2(4).

These principles are showcased in a 2007 court decision rendered in Ireland regarding the tax treaty between Ireland and Italy, where the court held with respect to the Irish capital gains tax imposed after conclusion of the treaty that “the new tax has to be identical or substantially similar to an existing tax whether that existing tax is Irish or Italian. Such an approach is consistent with the reciprocal nature of the Convention. It is also supported by the obligation of annual notification of tax changes by the contracting States.”<sup>259</sup> The High Court further stressed the significance of Art. 2.2 of the treaty, which specified the taxes which are to be regarded as taxes on income as “all taxes imposed on total income or on elements of income, including taxes on gains from the alienation of movable or immovable property”:

Had the Convention been intended to apply only to taxes which were in existence at the time that it was negotiated there would have been no need to include Article 2.2. It would have been sufficient to have Article 2.3. Indeed the fact that Article 2.3 speaks of existing taxes to which the Convention applies when read in conjunction with the remainder of Article 2 makes it clear that the Convention was designed to have prospective effect.

Regarding the existing taxes explicitly named in para. 3, and thus covered under the treaty, each state will be informed on the character of these taxes in the other state. An example for a decision to this effect by domestic administrative authority is a ruling issued by the Spanish Directorate General of Taxes,<sup>260</sup> which held that by inclusion of a list of taxes covered, both countries implicitly recognized that the taxes included by the other party were equivalent to the taxes included by itself.<sup>261</sup> Any other approach by the two sovereign states to their bilateral commitment may constitute an infringement of the principle of good faith, as the scope of the Convention would be obliterated where its scope keeps drifting apart as between the treaty partners.

The wording “in addition to, or in place of” is derived from the formulation “new taxes, or taxes replacing those to which the Convention applies” used in the Report of WP No. 3. The formulation “in addition to, or in place of” first featured in the Draft Conventions formulated by WP No. 3 (see Annex I). One could see this wording to suggest that only newly created taxes, as opposed to changes made to the existing taxes, are to be drawn within treaty coverage via para. 4. WP No. 30 uses the

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<sup>255</sup> Sic.

<sup>256</sup> FC/WP 30(69)1, m.no. 35.

<sup>257</sup> This view is taken also in K. Vogel, Commentary on Art. 2 para. 4, m.no. 53; Sutter in Aigner et al. (eds.) *Erbschaftssteuern und Doppelbesteuerungsabkommen*, p. 61; M. Lang in *liber amicorum Helmut Loukota*, p. 280.

<sup>258</sup> M. Lang, *Bulletin for International Fiscal Documentation* 2005, p. 221. Debatin, *Grundzüge der Abkommen zur Vermeidung der internationalen Doppelbesteuerung, Sonderdruck der Steuer- und Wirtschafts-Kurzpost* (1963) p. 17.

<sup>259</sup> *Lorraine Kinsella v. The Revenue Commissioners*, High Court of Ireland, decision of July 31, 2007, IEHC 250, m.no. 53.

<sup>260</sup> Ruling of 27 July 1999 regarding the 1995 Spain–France tax treaty, on the comparability of the French corporate income tax to the Spanish corporate income tax for purposes of the participation exemption under the Spanish tax regime; discussed by González-Cotera, “Spain: Tax Authorities Issue Rulings on ‘Comparable Income Taxes’ for Participation Exemption Purposes”, *European Taxation* 2000, pp. 153 et seq.

<sup>261</sup> González-Cotera, id., p. 155.



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open formulation that Art. 2(4) “makes clear that not only taxes being in force at the time of signature but also taxes subsequently introduced in a Contracting State will come under the scope of the Convention.”<sup>262</sup>

Taking into consideration the purpose of Art. 2(4) to prevent the treaty from becoming inoperative, and with a view to its drafting history as laid out above, the wording cannot be understood to mean solely those taxes that are newly created. The clause on automatic adaptation is intended to apply also to any subsequent changes made to the existing taxes.<sup>263</sup> Not to apply para. 4 to modifications of existing taxes would again leave the door wide open for states to circumvent treaty protection by avoiding to visibly create “new” taxes and rather changing an existing tax in substance.<sup>264</sup>

Moreover, in accordance with the objective in para. 4 to be mindful of the substance of what is taxed, it is well worth noting that an existing tax that was not previously included via para. 3 should not be precluded from coverage in the event that it is fundamentally altered to the effect that it is “identical or substantially similar” to a tax listed at the time of signature.<sup>265</sup>

Art. 2(4) expresses a commitment of the parties to the substance of their agreement also with respect to future developments in the domestic tax systems that leave the essence of bilateral commitment untouched. The commitment undertaken in a tax treaty containing a provision corresponding to para. 4 spans newly created taxes as well as modifications of the taxes covered. Such flexibility is not to be taken for granted in the international arena; it is of paramount importance in the fast-paced world of taxes.

Outside the boundaries of “substantially similar” cases lurks the inconvenience of renegotiations to amend the Convention. The report of WP No. 30 ostensibly comments:

[M]aking an amendment means that the Convention must run again through the machinery of parliamentary procedure; and these are not the only difficulties: the problem, for example, must also be dealt with, if the tax in question should be brought under the Convention *retrospectively*, a measure which would no doubt be desirable from the point of equal treatment of all income (capital) taxes of the Contracting States but would not be so desirable under the constitutional law of several Member States.<sup>266</sup>

Given the powerful impact the extension in para. 4 has on the application of a given tax treaty, it is not surprising that domestic court decisions on the substantive scope have centred on this provision. Throughout domestic court decisions, the litmus test by which substantial similarity is measured is an evaluation of the substantial characteristics of the tax, with particular weight on the nature of the taxable event. In a case regarding the Denmark–France tax treaty of 1957, the Danish Administrative Court held that it is not sufficient for a duty to be subsequently imposed in lieu of a tax mentioned in the list of taxes covered and held that a flat-rate tax on the gross amount of payments on the purchase of a pension could in no way be classified as substantially similar to an ordinary progressive tax on net income.<sup>267</sup>

Review authorities in the United Kingdom held that national insurance contributions paid during 1978 and 1979 did not fall within the reference to “income tax” in the UK–New Zealand treaty of 1966. Insurance contributions were not seen to be “of the same nature as income tax” for the purposes of New Zealand unilateral relief. The case was argued without reference to Art. 1(2) of that treaty, which corresponds to Art. 2(4) of the OECD Model and draws in “substantially similar” taxes, possibly

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<sup>262</sup> *Id.*, m.no. 7.

<sup>263</sup> See also the Commentary to the corresponding provision in the Mexico and London Draft Conventions of 1943 and 1946 (Commentary on resp. Art. I(2) that this provision is “intended to assure the automatic adaptation of the Convention to changes in the taxes of the contracting States. It does so by providing for the extension of the provisions.”

<sup>264</sup> See also this conclusion arrived at by M. Lang, *Bulletin for International Fiscal Documentation* (2005), p. 222.

<sup>265</sup> See also Baker, Commentary, 2B.06: “Presumably, however, an existing tax which was not included but which is fundamentally altered after signature could be drawn in.”

<sup>266</sup> FC/WP 30(69)1, m.no. 11 (emphasis in the original).

<sup>267</sup> Danish Administrative Tax Court (*Landsskatteretten*) Case No. 1985-5-173, decision of 22 May 1985; discussed in Weizman, “Scope of the Denmark-France Tax Treaty”, *European Taxation* 1994, pp. 27 et seq.

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because national insurance contributions were in existence in the United Kingdom well before the 1966 Agreement was signed. However, national insurance contributions in the United Kingdom have been the subject to major reforms in 1975 and subsequently.<sup>268</sup> It is arguable that certain categories of contributions as currently existing in the United Kingdom where the payment of contributions is not relevant in determining entitlement to individual benefits (“class 4 contributions”) come within the scope of existing conventions.

In a case before the Lower Civil Court of Paris, the issue was whether the 1985 Income and Capital treaty between Austria and France applied to the French net wealth tax, which was not expressly mentioned in Art 1(2) of the treaty as one of the French taxes covered. The Lower Court held that in the wording and the spirit of the treaty, an Austrian national who is subject to a tax in Austria similar to the French net wealth tax is not subject to the net wealth tax in France with respect to his shareholding in a French company. The Court’s reasoning was that the French tax authorities had not questioned the fact that the French net wealth tax was a tax which, if not identical to the Austrian capital tax, was at least similar to it.<sup>269</sup> The logic of the treaty containing a provision corresponding to Art. 2(4) suggests that where taxes on capital are mentioned in the general description of taxes covered, the French net wealth tax is automatically covered as a substantially similar tax introduced in France after the treaty was concluded.<sup>270</sup>

Another interesting issue in this regard came before the Austrian Administrative Court in 1999.<sup>271</sup> The Austria–UK tax treaty contained an exhaustive list of taxes which named the Austrian trade tax levied on enterprises with a permanent establishment in Austria. This tax consisted of three taxable elements: adjusted profits, adjusted capital, and the total amount of wages.<sup>272</sup> After this tax was abolished, the question arose whether the treaty was applicable also to a subsequently imposed tax that was a functional successor to the part of the tax base of the trade tax regarding the total amount of wages. The Court examined the substantial character of this tax (the so-called “*Kommunalsteuer*”, i.e. Municipal Tax), comparing its taxable object, the bearer of the tax burden, as well as the function and purpose of the tax in the domestic tax system to determine whether it qualified as “substantially similar” to the trade tax.

The Court concluded that the Municipal Tax was of a character substantially similar to an element of the former trade tax and thus held it to come within the scope of the treaty. In a similar ruling concerning the Municipal Tax under the Austria–Germany tax treaty, the Court affirmed its prior position that substantial similarity to one element of a former tax is sufficient to draw a subsequently imposed tax within treaty scope.<sup>273</sup> The rulings concerned treaties containing an exhaustive listing of taxes covered, but no general descriptions in the sense of Art. 2(1) and (2).

The situation might be different where treaties do not list the trade tax in Art. 2(3) but contain a general description in the sense of paras. 1 and 2 that mentions “taxes on the total amount of wages.”<sup>274</sup> Given the broad description in paras. 1 and 2, the newly introduced Municipal Tax seems to be covered by the general description “taxes on the total amount of wages or salaries paid by enterprises”. However, when commenting on proposed treaties, the Austrian tax authorities have consistently taken the position that even though the Municipal Tax might be covered under a general

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<sup>268</sup> See further the UK National Insurance Contributions Act 2008.

<sup>269</sup> Art. 3 of the treaty provided that capital was taxable only in the country of residence of the person holding the capital.

<sup>270</sup> Cf. Henry Lazarski, “Applicability of Tax Treaties”, *European Taxation* July 1985, pp. 200 et seq.).

<sup>271</sup> Austrian Supreme Administrative Court (*Verwaltungsgerichtshof*) Case No. 98/13/0021, decision of 15 December 1999.

<sup>272</sup> For a comprehensive analysis see Burgstaller, “Kommunalsteuer und DBA/Municipal Tax and Tax Treaties”, SWI 2004, pp. 17 et seq.; M. Lang, “Kommunalsteuer und DBA/Tax Treaties and Municipal Tax”, SWI 2005, pp. 16 et seq. See also the criticism of the Court’s decision regarding the nature of the municipal tax in Wurz, “Kommunalsteuer und Doppelbesteuerungsabkommen”, SWI 1998, pp. 231 et seq. See also the basic considerations in Firlinger, “Kommunalsteuer vom sachlichen Anwendungsbereich der DBA umfasst/Municipal Tax covered under Tax Treaties?”, SWI 1994, pp. 65 et seq.

<sup>273</sup> Austrian Supreme Administrative Court, Case No. 99/15/0265, decision of 3 August 2000.

<sup>274</sup> See the considerations of M. Lang, “Kommunalsteuer und DBA”, SWI 2005, pp. 16 et seq.

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description referencing taxes on the total amount of wages (“*Lohnsummensteuern*”), it is advisable to expressly mention the Municipal Tax in the list of taxes covered.<sup>275</sup>

## 6. The role of Paras. 1 and 2 in the light of Art. 2(4)

Paras. 1 and 2 have a similar objective to that pursued in Art. 2(4): the necessity for amendments is avoided to the extent that a tax, present or future, can be classified as coming under the general description of “taxes on income and capital”. Paras. 1 and 2, on the one hand, and para. 4, on the other hand, complement each other to obtain the overall objective of Art. 2 to “widen as much as possible the scope of the Convention.”

This explains why

the omission of paragraphs 1 and 2 could also cause problems with respect to subsequently introduced taxes: under the present O.E.C.D. concept, taxes being introduced after the signature of the Convention are automatically subject to the Convention, provided they are taxes on income (capital) within the meaning of paragraphs 1 and 2. This is the result of an interpretation of the present paragraph 4 in the light of paragraphs 1 and 2.<sup>276</sup>

The general boundaries of applicability of the treaty can be inferred from Art. 2(4) in its relation to the other paragraphs: the treaty will not apply to taxes that existed at the time of signature, but are not covered either under paras. 1 and 2 or para. 3.<sup>277</sup> The wording of para. 4 clearly ties in with para. 3 when it comes to determining whether the characteristics of a given tax are “identical or substantially similar” to those of the taxes listed in para. 3. While paras. 3 and 4 form a systematic unit, the role of the general descriptions in paras. 1 and 2 with regard to para. 4 is unclear. Is it correct to assume that paras. 1 and 2 also play an important role in determining the criteria for substantial similarity of a tax under Art. 2(4)? WP No. 30 stipulates:

At present, a subsequently introduced tax is considered to be ‘identical or substantially similar’ if it is a tax on income (capital) in the meaning of paragraphs 1 and 2. If, however, paragraphs 1 and 2 were omitted, the criterion ‘identical or substantially similar’ could be interpreted only in respect of the taxes enumerated in the list of taxes.<sup>278</sup>

Wassermeyer has expressed the view that from para. 4, it follows that para. 2 as well as para. 3 refer solely to taxes existing at the time of signature, because otherwise, para. 4 would have merely declaratory character.<sup>279</sup> Arguably, a tax that is “identical or substantially similar” to an existing tax listed in para. 3 will always be a “tax on income and capital” as per the treaty. However, the wording of Art. 2 clearly indicates that paras. 1 and 2 stand by themselves. The general description of taxes covered plays a role in determining similarity in substance and function as an “ultimate responsibility”<sup>280</sup> for the determination of the subject of the treaty, independently of any temporal frames. The broad commitment to a general designation in paras. 1 and 2 makes a test as to substantial similarity unnecessary; taxes that come under the description of “taxes on income and capital” will be covered even in the event that they are not identical or substantially similar to the taxes listed in Art. 2(3).<sup>281</sup> According to the purpose of paras. 1 and 2 to broaden as much as possible the scope of the Convention, their value in determining the taxes covered is independent of either Art. 2(3) or (4).

Naturally, the description of characteristic elements of the taxes covered in paras. 1 and 2 (“taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local

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<sup>275</sup> E.g. Austrian Ministry of Finance, Comments on the proposed double taxation convention between Austria and Qatar, GZ. BMF-010221/0782-IV/4/2010 (23 April 2010).

<sup>276</sup> Report of WP No. 30 (FC/WP 30(69)1) m.no. 12.

<sup>277</sup> See also Wassermeyer in Debatin/Wassermeyer, Commentary on Art. 2 para. 4, m.no. 69.

<sup>278</sup> FC/WP 30(69)1, m.no. 12.

<sup>279</sup> Wassermeyer in Debatin/Wassermeyer, Art. 2 para. 4, m.no. 69.

<sup>280</sup> FC/WP 30(69)1, m.no. 8; see the full quote supra Part II Chap. 3.

<sup>281</sup> This approach is taken by K. Vogel, Commentary on Art. 2 para. 4, m.no. 54; M. Lang, *Bulletin for International Fiscal Documentation* (2005), p. 221. Opp. Baker, Commentary on Art. 2 Paras. 1 and 2, m.no. 2B.04, stating that Paras. 1 and 2 are of practical significance only in determining what constitute “identical or substantially similar” taxes.

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authorities, irrespective of the manner in which they are levied”) will play a role also in the determination of identity or substantial similarity under Art. 2(4).

WP No. 30 illustrates this by way of an example:

State A and State B have enumerated income taxes which are levied (in both States) only on the *total* income. Assuming that State B introduces subsequently a special tax on interest, it might – in the absence of paragraphs 1 and 2 – be ambiguous if the new but special tax was ‘identical or substantially similar’ to the already listed taxes. State B might stress the fact that the new tax lacks of one decisive criterion which the already listed taxes have: it is not levied on *total* income; and therefore State B could refuse to treat the tax according to the Convention. Further similar examples could be furnished referring to every single criterion set forth in paragraphs 1 and 2. If a subsequently introduced tax bears such a criterion, but this criterion is not imminent to the already listed taxes, then it will – in the absence of paragraphs 1 and 2 – always be doubtful whether a justification can be found to call the new tax ‘identical or substantially similar’: thus it seems not to be quite clear whether a subsequently introduced *provincial* income tax comes under the Convention if the Contracting States refer in their lists only to *federal* taxes; similar uncertainty could be created by the introduction of a special tax *deducted at source*, if the list of taxes comprises only taxes levied by assessment, and so on.<sup>282</sup>

Para. 4 is of particular importance when a treaty has omitted general descriptions corresponding to paras. 1 and 2.<sup>283</sup> Conversely, due to the vagueness and generality of paras. 1 and 2, the extension under para. 4 in connection with para. 3 will be of importance in cases where a subsequently imposed tax cannot clearly be subsumed under the definition of para. 2. The standard of comparison in determining identity or substantial similarity of a tax under para. 4 is ultimately up to the contracting parties. A newly imposed tax that is not a “tax on income and capital” in the sense of paras. 1 and 2 will be covered if it is identical or similar in its substantial characteristics to a tax explicitly listed by either of the parties in para. 3. If the parties choose to incorporate a general description corresponding to paras. 1 and 2, a tax imposed after the date of signature and not listed in Art. 2(3) that qualifies as a “tax on income and capital” under paras. 1 and 2 will nevertheless be covered, unless it can be established that the tax was intentionally omitted from the list so as to exclude it from coverage. If, however, the tax does not clearly qualify as a “tax on income and capital”, it will only be covered if it can be seen to be identical or substantially similar to a tax listed in Art. 2(3).

Therefore, to the extent that a tax clearly comes within the descriptions of paras. 1 and 2, regardless of when it is created, this tax will indisputably be covered under the treaty. It is especially common in practice for contracting states to maintain reference in paras. 1 and 2 to taxes on capital, even if neither of the parties, at the time of conclusion of the treaty, levies a tax on capital. In case one of the parties subsequently introduces such a tax, it is automatically covered by way of paras. 1 and 2. By the same token, if one of the parties decides to abolish a tax that is covered under the general descriptions, notification to the treaty partner is required under Art. 2(4), last sentence. Such notification, however, has no effect on treaty scope of the treaty.<sup>284</sup> Coverage of a tax coming within the general description of paras. 1 and 2 is independent of whether the changes in domestic tax law are communicated to the treaty partner. Similarly, the extension to “identical or substantially similar” taxes under para. 4 is automatic and independent of notification of the treaty partner. Modifications to the scope of the treaty in these respects can only be achieved through bilateral negotiations and amendments; in the alternative, each party may exercise its right to unilateral suspension or termination under the provisions of the treaty or in accordance with the general rules of international law.<sup>285</sup>

Thus, both the general descriptions in paras. 1 and 2 and the extension clause in para. 4 have an important impact on tax treaty application: in a conflict of the contracting parties as to the classification of taxes under the treaty, making a successful argument that a tax comes under either of

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<sup>282</sup> FC/WP 30(69)1, m.nos. 14 and 15 (emphases in the original).

<sup>283</sup> See also K. Vogel, Commentary on Art. 2 para. 4, m.no. 52.

<sup>284</sup> See also the examples in M. Lang, BIFD 2005, p. 222; M. Lang in *liber amicorum Helmut Loukota*, pp. 283 et seq.

<sup>285</sup> Under the general rules of the law of treaties, grounds for terminating or suspending a treaty are material breach (Art. 60 VCLT), supervening impossibility of performance (Art. 61 VCLT), or fundamental change of circumstances (Art. 62 VCLT). For more on these grounds for termination, see Fitzmaurice, “The Practical Working of the Law of Treaties”, in Evans (ed.) *International Law* (2003) pp. 173 (196 et seq.).

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these provisions will defeat the treaty partner's possible allegations of wrongful treaty application or of interference with the balance of the treaty.<sup>286</sup>

## 7. Notification of changes under Art. 2(4)

The second sentence of para. 4 stipulates that the competent authorities<sup>287</sup> of the contracting states “shall notify each other of any significant changes that have been made in their taxation laws.”

No mechanism is provided for in the treaty to compel the contracting states to meet the requirement of notification.<sup>288</sup> Vogel referred to this provision as “a nobile officium of the contracting States, which derives from the very conclusion of the treaty and which would exist even if it were not expressly inserted in the DTC.”<sup>289</sup> Indeed, the “obligation”<sup>290</sup> of the state to notify the treaty partner of changes in its tax system can be derived from effective application of the principle *pacta sunt servanda* – that legally binding treaties should be carried out in good faith.<sup>291</sup> Although failure to notify the treaty partner does not give rise to legal consequences, it will entail political and economic consequences.<sup>292</sup>

Consistent with the principle of good faith, notification of changes in domestic (tax) laws serves a valuable purpose with regard to all aspects of application of the Convention. The question arises why it explicitly features in the context of the substantive scope in Art. 2. Provisions for the regular exchange of lists of the taxes in force in each contracting state can be found in treaty articles and protocols of some of the oldest treaties concluded.<sup>293</sup> Some treaties provided for an exchange of lists (on a regular basis or on the basis of occurrence of change in taxation laws) in addition to a non-exhaustive or exhaustive listing, while others did not provide for a list of taxes, but instead incorporated the requirement for periodical exchange of lists of the existing taxes in each of the contracting states.

In the Minutes of a 1956 Session of the OEEC Fiscal Committee it is set forth that upon examination of an initial Report of WP No. 3 “a discussion took place ... on the question whether Conventions should contain a list of the taxes to which they applied or whether a periodical exchange of lists was sufficient....”<sup>294</sup> WP No. 3 did not follow up on this discussion; however, the hitherto common “exchange of lists” was transformed into a “notification requirement” in the 1957 Draft versions of Art. 2 (see Annex I). The Commentary to the 1957 Draft of Art. 2 states: “Each State undertakes to notify to the other any amendments made to its taxation legislation, by communicating to it at the end of each year, when necessary, a list of new or substituted taxes imposed during that year.”<sup>295</sup>

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<sup>286</sup> See also the considerations with regard to the Danish exit tax under tax treaties in Weizman, “Departure Taxation – Treaty Override? – Extraterritorial Tax Law?”, *European Taxation* 2004, at p. 83.

<sup>287</sup> A definition of the term “competent authority”, meaning the authority that is to represent the state for the purpose of notification, is to be given by each of the contracting states in the treaty’s definitional article, usually Art. 3.

<sup>288</sup> See also the statement in this vein with regard to the corresponding provision in the US Model in Doernberg/van Raad, “The 1996 United States Model Income Tax Convention: Analysis, Commentary and Comparison” (1997) Art.2, para. 1-2 on p. 17.

<sup>289</sup> K. Vogel, Commentary on Art. 2 para. 4, m.no. 55c). See also Wassermeyer in Debatin/Wassermeyer, Commentary on Art. 2 para. 4, m.no. 73.

<sup>290</sup> The 2005 Income and Capital MC on Art. 2 para. 4, m.no. 8, as well as the Technical Explanation to Art. 2(4) of the 1996 US Model, explicitly speak of an obligation of the states.

<sup>291</sup> This principle is enshrined in Art. 26 of the VCLT, which provides that “[e]very treaty in force is binding upon the parties to it and must be performed by them in good faith.”

<sup>292</sup> Some scholars, according to the distinction between legal consequences, on the one hand, and political pressure and the pressure of market mechanisms, on the other, would qualify such an obligation as “soft law”, of which there is no accepted definition. For extensive analysis of the concept of “soft law”, see Lang/Schuch/Staringer (eds.) *Soft Law in der Praxis* (2005). A quick and concise insight is given by D. Shelton in Evans (ed.) *International Law* (2003) p. 145 (166).

<sup>293</sup> An example is the 1925 Germany–Italy Direct Taxes Convention, which states in m.no. 1 of the Protocol: “The central fiscal authorities of the two States shall at the end of each year exchange a list, corrected to date, of the impersonal taxes in force in each country.” Moreover, Art. 1 of this convention gave a non-exhaustive list for each of the states (“In particular, the following shall be regarded as impersonal taxation: ...”).

<sup>294</sup> OEEC, Fiscal Committee, Minutes of the 2nd Session held at the Château de la Muette, FC/M(56)2 (Prov.) at p. 6, under VI. (Listing and Definition of Taxes on Income and Capital which should be covered by Double Taxation Agreements).

<sup>295</sup> FC(57)1 of 17 October 1957, Commentary on the Draft Article, m.no. 11.

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Some treaties explicitly state that notification shall be made “if necessary for the application of this Convention”.<sup>296</sup> The US Model refers to “significant” changes in taxation laws; the Technical Explanation to the 1996 Model clarifies that “[t]he use of the term ‘significant’ means that changes must be reported that are of significance to the operation of the Convention.” Notification under the US Model shall be made by the contracting parties also as regards “other laws that affect their obligations under the Convention.”<sup>297</sup> The 1996 US Technical Explanation further stipulates that “[t]he competent authorities are also obligated to notify each other of official published materials concerning the application of the Convention. This requirement encompasses materials such as technical explanations, regulations, rulings and judicial decisions relating to the Convention.” The OECD Commentary is less rigid in this respect: “Contracting States are also free to extend the notification requirement to cover any significant changes in other laws that have an impact on their obligations under the convention.”

With regard to the purpose of the provision on notification of changes, the 1957 Commentary on the Draft Article of the Italian Delegate of WP No. 3 elaborates: “Each State binds itself merely to notify to the other contracting States all changes made to the existing taxes or any new taxes imposed, such a preliminary formality being necessary if the mutual consultation procedure provided in the last paragraph of the draft is to function.”<sup>298</sup>

Until the 1963 OECD Model Conventions, a provision regarding mutual agreement of the parties in unclear cases was commonly contained in the last paragraph of Art. 2. Upon analysis of the provisions to this effect in existing treaties, the 1969 Report of WP No. 30 endorsed the deletion of this provision from the text of Art. 2:

All these provisions deal with the question how the Convention could be adapted to alterations in fiscal law. The Working Party wonders if this question relates actually to Article 2, the principal function of which is solely to determine the subject of the Convention. Since those special provisions concern the Convention in its entirety it might be preferable to insert such provisions, if any, in an appropriate place in Chapter VI (special provisions) or Chapter VII (Final provisions) of the O.E.C.D. Model Convention.<sup>299</sup>

Whereas the provision on mutual agreement has a separate place in the OECD Model Conventions, the provision concerning notification of changes has consistently featured in the second sentence of Art. 2. The reason appears to be twofold: one aspect is that alteration in substantive respects to the taxation laws of a contracting state will regularly entail the question whether the changes produce “identical or substantially similar taxes” in the sense of the first sentence of para. 4. The other aspect as to why notification is dealt with in the context of substantive scope seems to lie in the fact that while the treaty in no way obliges the contracting states to continue to levy a tax mentioned in the treaty,<sup>300</sup> fundamental changes to the tax system of a contracting state may amount to a change of circumstances that provides ground for the renegotiation or termination of the treaty.

The provision on notification of changes is intrinsically linked with deliberations on whether a subsequently imposed tax can be seen to be “identical or substantially similar”. This is evidenced by the fact that the provision, originally intended to function as a “preliminary formality being necessary if the mutual consultation procedure provided in the last paragraph of the draft is to function”, was retained in the text of Art. 2. Although changes affect all aspects of the treaty, notification is especially crucial in that with respect to the substantive scope, the treaty explicitly ties in with future changes in defining the taxes covered.

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<sup>296</sup> An example is the Austria–Germany Income and Capital Tax Treaty of 24 August 2000, effective 1 January 2003.

<sup>297</sup> Second sentence in Art. 2(4) of the 2006 US Model. The Technical Explanation states that “[n]on-tax laws that may affect a Contracting State’s obligations under the Convention may include, for example, laws affecting bank secrecy.”

<sup>298</sup> FC(57)1 of 10 January 1957, Commentary by the Italian Delegate, m.no. 7.

<sup>299</sup> FC/WP 30(69)1, m.no. 50 (c).

<sup>300</sup> See the examples of possible interference of the parties in the balance of the treaty by M. Lang in *liber amicorum Helmut Loukota*, p. 283 et seq.

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Much consideration was given in the Report of WP No. 30 to the limitation of notification to “significant” changes. The deliberations were triggered by the proposition of the Delegate of the United Kingdom to eliminate the wording “at the end of each year” with regard to requirement for notification.<sup>301</sup>

WP No 3 states the following:

No distinction is made between important and less important changes. A strict interpretation of this provision means that any change, whether of any importance or not, even, e.g., in the position of a comma in a Finance Act of a State, should be notified to the other State. But even if the interpretation of the last sentence of paragraph 4 did not go so far, it would be obvious that this provision could not be carried out correctly but with great effort of administrative measures. The present rule that the modifications should be made at the end of each year is obviously a ‘concession’ to the tax administrations of the States concerned. If the proposition of the United Kingdom is regarded from this angle the question would immediately arise whether it would not bring about a *multiplied* work for tax administrations.<sup>302</sup>

The WP saw the question regarding frequency of notification to be interdependent with the character of changes to be communicated to the treaty partner via the notification provision:

But this proposition could also be seen from another side: the importance of amendments to the taxation laws varies considerably. It seems to be a matter of fact that most States are interested to know amendments of great importance but are not so interested to be informed about amendments of minor importance which are of no influence on the international tax relations. If the notification’s<sup>303</sup> provision in paragraph 4 could be interpreted (or amended) that way, i.e. that only major or essential changes are worth of notification, then it would seem to be quite a good solution that the notification is effectuated as when such essential change is made in the taxation law. The Working Party does not disregard that such a restrictive interpretation (or amendment) would probably require a discussion which sorts of changes in the taxation laws should be considered to be ‘essential’ and who should determine whether the change is essential or not.<sup>304</sup>

While no such requirement was inserted in the Model texts, treaties often expressly specify notification to only entail “essential” changes, or such changes that are “necessary to the application of the Convention”. Changes of “significant” character could be seen to be those changes that go beyond the mark of “identical or substantially similar taxes”.

If, on the other hand, notification entails any changes in tax laws, the contracting state whose competent authority notifies a new or altered tax without further comment appears to have acknowledged that this tax is “identical or substantially similar” in the meaning of the first sentence of Art. 2(4). A reaction from the other party may be deemed to be necessary to clarify that the new or amended tax is not automatically seen to come within the scope of the treaty.

From the perspective of transparency of contractual obligations, however, comprehensive notification seems preferable: each of the parties has a vital interest in being in a position to react to changes that may constitute a departure from the substantive scope agreed upon. The bilateral agreement is based upon the mutual perception of the treaty partner’s tax system and its concepts and principles. Any unilateral changes could potentially disrupt the common consensus of the parties, possibly amounting to a fundamental change of circumstances that might even prompt termination of the treaty.

The concluding considerations in the Report show how sensitive the issue is:

A restrictive interpretation of the last sentence of paragraph 4 might also meet a point raised by Canada. Canada does not use the concluding sentence of paragraph 4 because such a formal undertaking is considered to be unnecessary; it seems to be dangerous in that an oversight in providing information about a change would be a breach of the Convention.... [T]he Working Party is prepared to accept an argumentation saying that a restriction

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<sup>301</sup> FC/WP 30(69)1, m.no. 47: “*The United Kingdom* would prefer if the Contracting States notified each other of changes in their taxation laws not at the end of each year but when those changes are made and therefore suggests the omission of the words “at the end of each year” in the second sentence of paragraph 4” (emphasis in the original).

<sup>302</sup> FC/WP 30(69)1, m.no. 48 (emphasis in the original).

<sup>303</sup> Sic.

<sup>304</sup> FC/WP 30(69)1, m.no. 49.

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of the scope of paragraph 4 to ‘essential’ changes in the taxation laws would reduce such danger of ‘breaching the Convention’ to a justifiable minimum, provided, however, that the meaning of the term ‘essential’ could be determined sufficiently.<sup>305</sup>

The second sentence of Art. 2(4) is more than just a dispensable restatement of the treaty principle of good faith; it plays a vital role in the application of para. 4, as it indicates to the treaty partner that it might be necessary to examine whether an amended or newly imposed tax can be seen to be automatically covered by the treaty. The sensitive balance between the taxation systems of the contracting parties attained at the conclusion of the treaty should remain as stable as possible; a continuous dialogue enables either party to react to changes in the other party’s tax law and allows for consensual adjustments to the treaty or to policies employed in its application.

## **8. Summary of results**

By way of conclusion from the historical development of the structure of the current Art. 2, several findings can be pointed out. While the Draft Conventions and Commentaries of the League of Nations certainly form the starting ground for considerations in drafting Art. 2, the fact that the League of Nations Model text for Art. 2 remained largely without influence on bilateral treaties is reflected in the approach of the Working Parties of the OEEC and OECD. The Model texts of Mexico and London reflect pioneer work that distilled a framework for Art. 2 from the existing bilateral treaties. The foundational version of today’s Art. 2 was devised by WP No. 3 of the OEEC Fiscal Committee. The wording of the 1957 Draft Art. 2 as well as the considerations contained in the Reports of WP No. 3 not only determined the fabric of the 1963 Model Conventions, but they have had an impact that is to a great extent reflected in the current text of Art. 2. The Reports of WP No. 30 of the OECD Fiscal Committee identified points where clarification may be necessary, which were largely implemented in the 1977 Model texts.

The structure and wording of the US Model treaty has its foundations in the League of Nations Draft Conventions. However, due to active involvement in the process of devising and improving on the OEEC/OECD Model texts, there have been no major conceptual differences in the approach to Art. 2. Effective January 2007, the US Model adopted the structure of Art. 2 as contained in the OECD Income and Capital MC and adopted the OECD Model text almost verbatim.

The fact that the drafting efforts of the OEEC were based on the analysis of existing treaties and regular discussions among Delegates from Members as well as non-Member countries has led to a remarkable track record of adherence to the draft texts in bilateral tax treaties. This, along with its broad wording and equally broad reference to subsequently introduced taxes, accounts for the fact that Art. 2 has remained virtually unchanged throughout its drafting and negotiating history.

## **PART III Looking behind the formal structure of Art. 2: The substantive scope of tax treaties**

### **A. General concept of taxes covered**

#### **1. The concept of “tax” in Art. 2**

The notion of “tax” is a constituent foundation of the provision on “taxes covered”, but neither the OECD Model Conventions and Commentaries nor individual tax treaties provide a distinctive

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<sup>305</sup> Id., m.no. 50.



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definition of the term.<sup>306</sup> The following analysis aims to extract the essence of the term as used in the provision on taxes covered.

### 1.1. Common conceptual principles

From the perspective of the provision for the elimination of double taxation,<sup>307</sup> the extent of payments that are seen as being covered under the treaty is particularly important under the “credit method”. If a payment qualifies as a tax under this article, credit will in most cases be given by the residence state for the payment at source even in cases where this payment is of a totally different nature than the tax against which it is credited.<sup>308</sup>

The term “tax” has a key function not only in the treaty article on substantive scope, but also in the provisions on non-discrimination, exchange of information and assistance in the collection of taxes.<sup>309</sup> An entirely different understanding of the term “tax” may be called for in these respective contexts.

On its face, the meaning of the term “tax” appears to be clear and universally understood. Historically, the legal notion of tax evolved along similar patterns in all countries, and developments seem to have been transported among nations. Adam Smith observed in *Wealth of Nations* (1776): “There is no art which one government sooner learns of another than that of draining money from the pocket of the people.”

A comprehensive definition of the nature of “tax” is unattainable, as the notion is subject to complex social, economic and legal dynamics that work out differently across the nations and even within legal systems. There are vast discrepancies in detail depending on the context the term is used in.<sup>310</sup> Accepting that the standards to be met are far from static, basic elements of the concept of “tax” that are common to tax laws in the different countries serve as a touchstone in determining the taxes covered under tax treaties. The approach to be taken to determine whether a certain payment qualifies as a tax covered under tax treaties is one of approximation and of weighing up elements of more or less intensity against each other. The purpose of tax treaties warrants for a typological, flexible term of tax whose elements can be concretized by the contracting parties. To be aware of these elements can be of substantial support in the negotiation and application of tax treaties.

Domestic tax laws usually do not provide a definition of what is a tax as covered by their tax treaties; recourse to domestic law under Art. 3(2) will thus not produce any results.<sup>311</sup> It is usually economic and legal doctrine that deals with the notion of tax. From a comparative point of view, the concept of tax does not differ significantly from one country to another. As discussed at the 9th Meeting of the EATLP in 2005 on “The Concept of Tax”,<sup>312</sup> an integrated approach is to be taken for purposes of tax treaties based on the OECD Models. Common general definitions, legal theory and decisions of courts in the different nations mirror key elements of the concept of tax that are independent of stand-alone domestic concepts and valid also in the context of tax treaties.

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<sup>306</sup> Treaties sometimes mention the term in the provision on general definitions; however, definitions remain rather uninformative. An example is the Germany–Ireland Income Tax Treaty of 1962, which stipulates in Art. II(1)(a) (General Definitions): “In this Convention, unless the context otherwise requires: The term “tax” means Federal Republic tax or Irish tax, as the context requires.”

<sup>307</sup> Art. 23 of the OECD Income and Capital Model Tax Convention; Art. 9 of the Estates, Inheritances and Gifts Model Tax Convention.

<sup>308</sup> See also 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”, *Bulletin for International Fiscal Documentation* 2005, p. 432.

<sup>309</sup> Arts. 24, 26 and 27 of the OECD Income and Capital Model Tax Convention respectively deal with non-discrimination, exchange of information and assistance in the collection of taxes. There are analogous provisions regarding non-discrimination and the exchange of information in Arts. 10 and 12, resp., of the Estates, Inheritances and Gifts Model Tax Convention.

<sup>310</sup> Cf. similar considerations in Heij, “The Definition of Tax”, *Asia-Pacific Tax Bulletin* 2001, pp. 74 et seq.

<sup>311</sup> See also Van Raad, “The Concept of Tax in the OECD Model”, Paper for the 9th Annual EATLP Meeting on “The Concept of Tax” held in Caserta, Italy (2005).

<sup>312</sup> 9th Annual EATLP Meeting, “Il Concetto di Tributo/The Concept of Tax”, held in Caserta, Naples (Italy) from 26-28 March 2005.

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Based on common conceptual principles across the nations, the considerations that follow intend to provide a framework that can function as a coherent basis in the effort to ascertain whether a levy at issue qualifies as a tax covered under treaties patterned on the OECD Models. Identifying common characteristics indicating a “tax” for purposes of tax treaty application can help foresee common interpretive problems and trigger discussions of country-specific issues during treaty negotiations.

The focus in the process of qualifying a payment as a tax coming within the scope of a treaty must logically be on the essential characteristics of the payment rather than its denomination.<sup>313</sup> Chapter to this line of thinking was given, for example, in the Commentary to the Model Tax Conventions of Mexico and London: “The Convention is intended to apply to all ordinary and special taxes on individual and corporate income, *whatever may be their denomination* and method of assessment.”<sup>314</sup>

Such an approach of “substance over form” is vital to the application of international agreements. Regarding the substantive scope of the EC Parent-Subsidiary Directive, the ECJ held that a tax that had the same effect as a tax on income was to come within the scope of the Directive, irrespective of the fact that it was called an inheritance and gift tax under domestic law.<sup>315</sup>

Whether a legal provision labels a payment as a “tax” can never be more than an indication of its nature<sup>316</sup> because denominations will in many cases be the result of political and budgetary considerations rather than an assessment of the character of the levy. In fact, it is a widespread phenomenon among governments in the different states to avoid a clear distinction between “taxes” and other government levies, because the implementation of a “tax” (or its notional equivalent in the language of the respective state) will generally be more unpopular with taxpayers than a levy termed otherwise.<sup>317</sup> The characteristics of a payment as opposed to its labelling by government are often invoked in constitutional law in the different countries.<sup>318</sup> Whichever way a payment is termed in the respective state, it may come within the scope of tax treaties if its characteristic features are such that it can be seen to be a “tax in all but name”. Therefore, the key question to be answered is: What is the substance of a “tax” that qualifies as pertaining to “taxes covered” under a tax treaty adopting the OECD Model texts?

In the context of tax treaties, one element of the term “taxes” that suggests itself is their pecuniary nature; the application of tax treaties presupposes a payment of money. Along with the fact that taxation is public in nature, its pecuniary character is rooted in its basic purpose of contributing to public treasury. However, as reflected in most generic definitions,<sup>319</sup> pecuniarity is not to be taken for granted in all contexts. For purposes of the OECD Revenue Statistics, the OECD “Glossary of

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<sup>313</sup> See also Büge in Becker/Höppner et al., Commentary on Art. 2 para. 1, m.no. 12.

<sup>314</sup> League of Nations, Fiscal Committee, London and Mexico Model Tax Conventions – Commentary and Text (Geneva, November 1946) C.88.M.88.1946.II.A, Commentary on the Model Bilateral Convention on the Prevention of the Double Taxation of Income and Property, Ad Article I – Object and Scope of the Model Convention, p.11 (emphasis added).

<sup>315</sup> C-375/98, *Ministério Público and Fazenda Pública v. Epson Europe BV*, Judgment of 8 June 2000, ECR I-4243.

<sup>316</sup> This approach appears to be universal in jurisprudence throughout the nations. Examples are the Australian case *The King v. Caledonian Collieries Limited* (1928) A.C. 358 (“The nature of the tax is the question of substance and does not turn on the language used by the legislature.”) and the US case *United States v. LaFranca*, US Supreme Court (1931) 282 U.S. 568 (“No mere exercise of the art of lexicography can alter the essential nature of an act or a thing; and if an exaction be clearly a penalty it cannot be converted into a tax by the simple expedient of calling it such.”).

<sup>317</sup> See also Dahmén, “Tax or Charge – What is the difference, if any?”, in Lindencrona et al. (eds.) *International Studies in Taxation: Law and Economics, liber amicorum Leif Muten* (1999) p. 105 (108).

<sup>318</sup> For more on such provisions governing fiscal federalism in Austria, see Raschauer, “Abgabenbegriff und Rechtsformenmissbrauch”, in *liber amicorum Stoll* (1990) p. 214 (215); M. Lang, “Die Geldleistung an eine Gebietskörperschaft als Kriterium des finanzverfassungsrechtlichen Abgabenbegriffs”, in Akyürek/Metin et al. (eds.) *Staat und Recht in europäischer Perspektive, liber amicorum Heinz Schäffer* (2006) pp. 411 et seq.

<sup>319</sup> *Black’s Law Dictionary* states: “Although a tax is often thought of as being pecuniary in nature, it is not necessarily payable in money.” Most law dictionaries, however, see taxes to be pecuniary payments: *Oran’s Dictionary of the Law* defines tax as “a required payment of money to support the government.” *Random House Webster’s Pocket Legal Dictionary*: “[A] sum of money required to be paid to the federal, state, or local government for the support of government activities and services to the public at large.” *Barron’s Law Dictionary*: “[A] rate or sum of money assessed on a person or property for the support of the government.”

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Statistical Terms” describes taxes as payments in cash or in kind.<sup>320</sup> However, taxation addressed in tax treaties must be explicit in the sense that there is budgetary evidence of the taxation event.<sup>321</sup>

As a starting point in the interpretation of tax treaty terms, dictionary definitions have often been cited by courts and administrations.<sup>322</sup> Recurring in legal definitions across the nations is the description of “taxes” as compulsory contributions to revenue that are imposed by government authorities.<sup>323</sup> Voluntary payments do not have the character of “taxes” in the proper meaning of the word.

An interesting issue in this context is whether a refund not granted to the taxpayer may be seen as a tax under the treaty. The Federal Tax Court of Germany decided a case concerning a refund that the taxpayer had been entitled to in the source state but which he did not claim in due time.<sup>324</sup> The question arose whether, in the amount exceeding lawful withholding in the source state, the taxpayer could claim a credit for this “tax” in the state of residence under the provision conforming to Art. 23 of the OECD Model text.

The Court decided against a credit under the treaty, as the amount exceeding maximum credit cannot be considered to have been taxed in the source state “in accordance with the provisions of this Convention”, given the fact that the source state did not have any domestic taxing jurisdiction regarding this amount in the first place. This corresponds to a principle commonly followed by countries that grant foreign tax credits: refundable amounts do not count against the foreign tax credit, as a refund is in essence a grant. Lang noted that the Court’s decision in fact leads to the only result feasible and practicable: any other approach would open the floodgates to collusion between the taxpayer and the tax authorities of the source state to effectively shift the burden of granting relief from double taxation to the residence state.<sup>325</sup> Many credit states have specific rules explicitly denying a credit for “voluntary” taxes and usually employ the words “subject to the provisions of domestic law” in their version of Art. 23. This is not a novel issue: the 1924 draft for a treaty between Danzig and Poland clarified in Art. IX para. 2 that “[t]axes already collected shall be refunded in accordance with the regulations of the Party which is responsible for making the refund.”<sup>326</sup>

Therefore, it can be concluded that the fact that a payment may be refundable or creditable does not preclude its character of a tax covered under tax treaties, so long as there was an actual taxation event that the treaty ties in with.<sup>327</sup>

One aspect of the element of “compulsion” expressed in the various definitions (“compulsory”, “enforced”, “imposed”, “involuntary”) is that the taxpayer has no choice of whether or not to make the payment. The very notion of tax, in itself and of necessity, suggests imposition independent of individual consent. Stiglitz noted in his standard work on public finance that “taxes are inevitably painful.”<sup>328</sup> Where pecuniary burdens directly result from decisions of a voluntary nature on the part of the payer, e.g. the decision to acquire a permit, the payment will in principle not be a tax for tax treaty purposes. However, the mere observation that payments result from an act or decision of the payor will not in all cases per se take away from their compulsory character, as a certain extent of

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<sup>320</sup> OECD, Revenue Statistics 1965–2005, 2006 edn, published 17 October 2006. The Glossary draws from international statistical guidelines prepared by international organizations such as the UN, ILO or IMF.

<sup>321</sup> The distinction between “explicit” and “implicit” taxation was coined by A. R. Prest; for more information on this definition see Heij, *European Taxation* 2001, p. 78.

<sup>322</sup> Edwardes-Ker (1996) Chap. 7, p. 3.

<sup>323</sup> *The Concise Oxford Dictionary of Current English* defines “tax” as “a contribution to state revenue compulsorily levied on individuals, property, or businesses”. *Oran’s Dictionary of the Law* states that “tax” is “a required payment of money to support the government”.

<sup>324</sup> German Federal Tax Court (BFH) Case No. I R 37/83, decision of 21 May 1986.

<sup>325</sup> Cf. M. Lang, *Bulletin for International Fiscal Documentation* (2005), p. 219.

<sup>326</sup> Agreement between the Free City of Danzig and the Republic of Poland with a view to the adjustment of Taxation by the two States and in particular the Prevention of Double Taxation in the matter of Direct Taxes; unperfected, published 17 March 1924.

<sup>327</sup> See also Debatin/Wassermeyer, Commentary on Art. 2 para. 2, m.no. 26.

<sup>328</sup> Stiglitz, *Economics of the Public Sector* (2000) p. 456.

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unfettered choice is intrinsic to society.<sup>329</sup> The delimitation from services rendered at the taxpayer's request will sometimes be blurred.<sup>330</sup>

An essential feature of taxes is that they are imposed "authoritatively" by way of an act of state sovereignty. Some authors have argued that the fact that a payment is enforceable by the government automatically renders it a tax.<sup>331</sup> While it is a valid finding that any tax is "taken rather than paid", the broad distinction between voluntary and involuntary payments is not sufficient to resolve unclear cases. A marker of distinction sometimes used in domestic court decisions<sup>332</sup> is that taxes do not involve any contractual or *do ut des* relationship between government and the payer. Such payments, for example payments with regard to tax liens or bonds obtained through a contract with government authorities, are outside the scope of tax treaties.

The involuntary character of taxes is closely linked to the existential justification of government in the large: taxes are used to fund the social costs of society as a whole and thus to provide "common welfare". There is no incentive whatsoever for the individual to keep adding to the common fund where citizens can freely resort to the social benefits provided by society. To quote Justice Oliver Wendell Holmes, "Taxes are what we pay for civilized society."<sup>333</sup> This thought reflects the universally accepted and very general requisite that taxes are to be used for public purposes, i.e. to defray public goods and services such as public safety, the printing of currency, a functioning court system, transportation and education, etc.<sup>334</sup>

Some definitions expressly stress the fact that taxes are to be used for public purposes in that taxes should be used to finance "public goods".<sup>335</sup> From the perspective used in this thesis, this common understanding is not to be mistaken with what has been called the "benefit principle of taxation" in mainstream economic theory.<sup>336</sup> The "benefit principle" is the idea that taxes are justified in that they are levied in proportion to services provided by government that help to produce private profit. Another, nowadays more commonly invoked, principle for justifying the imposition of a tax is the principle of "ability to pay", which postulates that persons should sacrifice to government according to their respective abilities to pay in terms of material wealth.<sup>337</sup> Both of the said principles are accommodated in the allocation of taxing rights under the OECD Model Conventions.

To determine whether there is a sufficient connection for assigning tax jurisdiction under a treaty, the drafters of the OECD Model texts considered the territory principle and the direct benefit principle.<sup>338</sup>

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<sup>329</sup> Regarding the decision to operate a business, cf. the considerations under II.A.1. in Blegen, 104 Comm.L.J. 97 (1999).

<sup>330</sup> See the considerations by Lorenzo del Federico, "The concept of tax and the commutative taxation", p. 44 (45) of the Conference Paper on "The Concept of Tax in EU Member States - General Introduction and Comparative Analysis" by Peeters/Barassi/Barker et al., prepared for the 9th Annual EATLP Meeting on "The Concept of Tax" in Caserta, Italy (2005).

<sup>331</sup> Brennan/Buchanan, *The Power to Tax - Analytical Foundations of a Fiscal Constitution* (1980) Chap. 9.1.25: "For the ordinary citizen, the power to tax is the most familiar manifestation of the government's power to coerce."

<sup>332</sup> See, for example, *Farmers Frozen Food Company*, 221 F. Supp. 385 (N.D. Cal. 1963) regarding the distinction between taxes and other assessments, where "voluntary" is understood in the sense of "contractual".

<sup>333</sup> In the US Supreme Court case *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, decision of 21 Nov 1927, 275 US 87; 48 S Ct 100; 72 L Ed 177.

<sup>334</sup> This has been seen to be rooted in utilitarianism, which sees taxes as a contribution to a common societal goal, as opposed to libertarianism, which basically sees taxation as a form of expropriation. For more on what have been called "the libertarian vs the utilitarian views of taxation", see Barker/Vording, "The relevance of a concept of tax - Normative considerations", paper for the Meeting of the EATLP on "The Concept of Tax", held in Caserta, Italy on 26-28 March 2005.

<sup>335</sup> Cf. a definition that has been quoted and endorsed by US courts: "Taxes are the enforced proportional contributions from persons and property, levied by the state by virtue of its sovereignty for the support of government and for all public needs." [Cited in Brian E. Garner (ed.) *Black's Law Dictionary*, 8th edn. (2004) from the original: Thomas M. Cooley in Clark A. Nichols (ed.) *The Law of Taxation*, 4th edn. (1924) p. 61.]

<sup>336</sup> A comprehensive account of the "benefit principle" in public finance can be found in Musgrave, *The Theory of Public Finance - A Study in Public Economy* (1959) pp. 61 et seq.

<sup>337</sup> This principle is foundational in the income tax systems of many countries. For a critical analysis, see Gassner/Lang, "Die mangelnde Leistungsfähigkeit des Leistungsfähigkeitsprinzips", *ÖStZ* 2000, pp. 643 et seq. See also Geier, "Time to bring back the 'benefit' norm?", *TAWD* 2004, pp. 41 et seq.

<sup>338</sup> Cf. K. Vogel, "Worldwide vs. Source Taxation of Income: A Review and Re-evaluation of Arguments (Part III)", *Intertax* 1988, 393 et seq.; Rixen, "Why Bilateralism? - Cooperation in International Double Taxation Avoidance", Conference Paper, available online at [www.gsa.iu-bremen.de/data/Rixen.pdf](http://www.gsa.iu-bremen.de/data/Rixen.pdf).

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Professors Bruins, Einaudi, Seligman and Stamp, in their 1923 Report on Double Taxation, discussed the direct benefit principle as part of the principle of ability to pay: “So far as the benefits connected with the acquisition of wealth increase individual faculty, they constitute an element not to be neglected. The same is true of the benefits connected with the consumption side of faculty.”<sup>339</sup>

These principles, however, are merely a vehicle to allocate tax jurisdiction in the treaty context; principles on tax fairness and equality of taxation of domestic tax systems are of no import for purposes of tax treaty application, as tax treaties follow existing tax burdens. Moreover, fairness considerations cannot logically be of use at this point of the study, as they presuppose as their very conceptual corollary a notion of tax and aim to provide a test and measure of how the burden of tax is to be apportioned; therefore, they cannot yield results with respect to what constitutes a “tax”.<sup>340</sup>

A clear indicator of special benefits preventing classification as a tax is the conclusion that if it were used to fund general revenue, the imposition would constitute a “confiscation”.<sup>341</sup> However, there are cases where it is open to argument whether a special benefit rather than a benefit to the general public is granted. Payments for services and utilities such as garbage disposal, lighting, sewer systems, storm drains or other infrastructure needs can be seen to directly benefit specific areas, and thus to benefit not the public at large but certain individuals. Where the individual incurs an expense that is met with a corresponding benefit, the nature of the payment is not that of a tax for tax treaty purposes.

In domestic court cases, the “public purpose” requirement of taxes is usually seen to be fulfilled even if the funds collected are segregated from the general revenue pool in that they are earmarked by government to finance specific kinds of public expenditure.<sup>342</sup> Earmarking a tax towards financing specific public goods and services that all taxpayers pay for may occur with respect to different areas in the various countries, e.g. higher education, research, health care, railroads, etc. The broad notion of “public goods” hinges upon common perception in the respective country,<sup>343</sup> and the line between taxes and payments for certain benefits will often be tenuous.

This is exemplified in the case of levies regarding television and radio where these services are provided by public authorities. Domestic jurisprudence in this area varies across the nations and may at times be ambiguous even within domestic jurisprudence.<sup>344</sup> While the criteria to measure whether a payment is a “requited” payment rather than a tax remain uncertain, the basic distinction of taxes as opposed to payments that trigger individual services in return is consistently sustained throughout the nations. Where the payment is not directed toward the individual as such but rather aimed at the individual as part of society, any identifiable benefit to the individual being more or less incidental, the payment may qualify as a tax that comes under tax treaties. This distinction has also been used by the ECJ.<sup>345</sup>

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<sup>339</sup> League of Nations, Economic and Financial Commission, Report on Double Taxation, Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Stamp, Geneva, 5 April 1923 (F.19) at 18.

<sup>340</sup> See also the remark that constitutional principles in the various nations such as legality and ability to pay do not influence the notion of tax in Barassi, “The notion of tax and the different types of taxes – Comparative Law Approach”, p. 32 (35) of the Conference Paper on “The Concept of Tax in EU Member States – General Introduction and Comparative Analysis” by Peeters/Barassi/Barker et al., prepared for the 9th Annual EATLP Meeting on “The Concept of Tax” in Caserta, Italy (2005).

<sup>341</sup> See also the arguments made with regard to “special assessments” on property in Blegen, “Would a Tax by any other Name Smell as Sweet? The Treatment of Special Assessments in Bankruptcy”, 104 *Commercial Law Journal* 97 (1999).

<sup>342</sup> Cf. the Austrian Supreme Administrative Court, Case No. B 514/04, decision of 14 December 2004; US Court of the Northern District of California, *Farmers Frozen Food Company* (1963) For more on the treatment of earmarked taxes for purposes of the substantive scope, see Part III, Chap. 1.2.6.

<sup>343</sup> See also Heij, “The Definition of Tax”, *Asia-Pacific Tax Bulletin* 2001, p. 76.

<sup>344</sup> See, e.g., the Belgian Constitutional Court on levies in the audio-visual sector, which were not regarded as a tax: *Cour d'Arbitrage*, Case No. 117/2002, decision of 3 July 2002; however, the Belgian Judicial Court (*Cour de cassation*) has sometimes held the same levy to be a regular earmarked tax. See also Bourgeois, “Constitutional framework of the different types of Income”, p. 49 (74) of the Conference Paper on “The Concept of Tax in EU Member States – General Introduction and Comparative Analysis” by Peeters/Barassi/Barker et al., prepared for the 9th Annual EATLP Meeting on “The Concept of Tax” in Caserta, Italy (2005).

<sup>345</sup> See ECJ, case C-130/93, ECR 1994, I-03215, on the issue whether a compulsory contribution is in accordance with Arts. 9 and 12 of the EC Treaty: “[A] charge which is imposed on goods ... may escape classification as a charge having equivalent effect as prohibited by the Treaty ... if it represents payment for a specific service actually and individually rendered to the trader of a sum in proportion to that service.”

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The OECD Model Conventions are in line with this conceptual approach. While the Model Commentaries do not explicitly give chapter for this distinction, the 1969 Report of WP No. 30 contains a statement in this vein: “In theory, payments made upon a legal obligation are normally qualified as ‘taxes’ if they are made *without any specific return*.”<sup>346</sup>

The *IBFD International Tax Glossary*, which is frequently referenced by practitioners and researchers alike, states: “There is no single definition of a tax and definitions tend to vary according to the context. In general a tax may be defined as a government levy which is not in return for a specific benefit...” Moreover, mention is made in this glossary of the OECD Glossary of Tax Terms, which asserts: “The OECD working definition of a tax is a compulsory unrequited payment to the government.” While the OECD Glossary does not further elaborate, the IBFD’s definition goes on to state: “It is unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their tax payments...”

Seligman, one of the authors of the 1923 report submitted to the League of Nations Fiscal Committee that served as the basis for the first Draft Double Taxation Conventions,<sup>347</sup> noted: “Where the government actually performs a definite service for the particular individual, the benefits of which are separably and measurably calculable, these payments do not come under the head of taxes, properly so-called, but they are fees.”<sup>348</sup>

Whenever the payment secures concrete government action or the concession of certain commodities to the individual payer, it is not a tax in character and will generally be outside the scope of tax treaties. However, the notion of “benefit” is ultimately defined by government and often does not coincide with an actual subjective benefit of the payer, who may view the involvement of government as an intervention. An example is the case of stamp duties levied upon drawing up a contract between private individuals. Such duties levied on paper and electronic transactions are generally seen to be outside treaty scope. Some income tax treaties expressly list stamp duties in Art. 2.<sup>349</sup> Unless expressly mentioned, these duties are not within the notion of tax in international tax language. However, where the basis of a stamp duty is the value of assets transferred, the duty can be qualified as an inheritance or gift tax; thus, stamp duties are sometimes included in inheritance and gift tax treaties.<sup>350</sup>

Other payments regularly seen to be requited and thus not covered under tax treaties are user charges, court fees, passport fees and royalties paid to the state for the extraction of natural resources such as minerals or oil. Nevertheless, the fact that there is room for contention in practice as regards the distinction between taxes and payments for certain benefits is showcased in the area of royalty payments: oil-rich states have sometimes been known to levy “profits taxes” instead of royalties in order to obtain relief under tax treaties.<sup>351</sup>

Thus far, it can be observed that the concepts of tax on the one hand, and payments for certain benefits on the other hand, albeit commonly used as distinct notions, cannot be clearly differentiated in a global approach but rather on a case-by-case basis, weighing up the elements laid out in the above. The concept of tax in tax treaties is not a clear-cut analytical concept. There are in substance

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<sup>346</sup> FC/WP 30(69)1, m.no. 27 (emphasis in the original).

<sup>347</sup> Cf. 1925 League of Nations Double Taxation and Tax Evasion – Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations, under Part II.1.: “[W]e have profited by the results of the investigations undertaken and completed by the Special Committee of Economists ... a most important work of economic analysis which ... served as the basis for our work. This masterly report has been of inestimable value to us.”

<sup>348</sup> Seligman, “The Progress of Taxation during the Past Twenty-Five Years, and Present Tendencies”, AEAQ, 3rd Series, Vol. 11, No 1 (1910) p. 331 (342).

<sup>349</sup> See, e.g. Art. 2(3)(b)(iii) of the China–Macao Income Tax Treaty of 27 December 2003, effective 1 January 2004.

<sup>350</sup> See, e.g., the Nordic Convention on Estates, Inheritances, and Gift Taxes of 12 September 1989, effective 18 October 1992. “Stamp taxes” are oftentimes expressly incorporated in treaties with African states; see, e.g. the Benin–France Income, Inheritance, Registration and stamp Tax Treaty of 27 February 1975, effective 1 January 1977.

<sup>351</sup> See Baker, Commentary, 2B.12, with references to case law.

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certain core characteristics of taxes that recur in economic and legal definitions as well as in court decisions of the various nations, and that are suitable also in the tax treaty context: taxes are involuntary pecuniary burdens imposed by way of state sovereignty on all taxpayers, regardless of whether they utilize goods and services provided to the public at large. Moreover, it should be stressed that an exclusive financing function of taxes is not a prerequisite to the concept, as taxation has increasingly become an instrument allowing government to realize its social and economic policies, most importantly redistribution.

The fact that the concept of tax in Art. 2 is fraught with definitional problems which make conclusive answers virtually impossible does not render further considerations pointless; quite the opposite is true: as shown in the following, it is a worthwhile effort to refine perception through further analysis of elements that play a role in the wording of Art. 2 as well as in the tax treaty context.

A straightforward indication as to the concept of “taxes” under Art. 2 of both Model Conventions is the statement in para. 2 that the taxes described are covered “irrespective of the manner in which they are levied”. Whether taxes are levied directly or by way of withholding at the source, whether they are levied on a certain percentage that may be linked to specific factors, or even to the percentage of another tax, etc., the method of its assessment under domestic law has no bearing on the tax treaty coverage of the levy. Moreover, from this it can be concluded that the manner in which taxes are collected is irrelevant to treaty application. Government may outsource tax collection. Lawmakers in the United States, for example, have allowed private debt collectors to collect taxes due; as an incentive, the private collectors may keep 25% of the amount collected. Opponents of this practice, which was signed into law with the passage of the American Jobs Creation Act of 2004, have argued that such collection of taxes undermines the inherently governmental character of taxation.<sup>352</sup>

Arguably, net accretion to the government’s budget is not a necessary feature of taxes. Lozev makes this argument in the context of an envisaged compensatory tax in Bulgaria on interest income from countries that withhold payments in compliance with the EC Interest and Savings Directive.<sup>353</sup> While different taxes have different immediate goals and vary with respect to revenue effects, the body of taxes as a whole nevertheless aims at increasing government funds. It should be noted, however, that where a levy is aimed at reimbursing government authorities for services rendered previously or subsequently, it is a fee in nature rather than a tax, and no tax treaty coverage is warranted.

As the OECD Model Commentary to Art. 2 stresses that the article is designed to “broaden as much as possible the scope of the Convention,” the substantive scope crucially hinges upon the determination as to a broader or narrower conception of “taxes”.

## **1.2. Indirect taxes**

The *IBFD International Tax Glossary* expresses a common legal distinction: “Taxes may be direct or indirect, depending upon whom the incidence of the tax burden falls.”

Most commonly within the category of “indirect taxes” are taxes on the consumption of goods and services collected at the final (retail) level or at various stages of production and distribution, usually referred to as value added taxes (VAT). Value added taxes and similar turnover taxes can be found in the vast majority of tax systems across the globe. While they are implemented differently around the world and across OECD Member countries, there are common core features. VAT is usually levied on a broad base (as opposed to excise taxes, which cover specific products). The tax is collected in a staged process based on the production/distribution chain, with successive taxpayers entitled to deduct

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<sup>352</sup> See further Yvonne R. Cort and Karen J. Tenenbaum, “More Ways to Collect from Taxpayers – IRS can use private debt collectors”, article on file with the author.

<sup>353</sup> K. Lozev, “Implementation of the Savings Directive in Bulgaria – Selected Issues”, 48 *European Taxation* 10 (2008) p. 534 (538) makes this argument in the context of an envisaged compensatory tax on interest income from countries that withhold payments in compliance with the EC Interest and Savings Directive.

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input tax on purchases and account for output tax on sales. In general, OECD countries with value added taxes impose the tax at all stages and allow immediate deduction of the tax upon purchase by all but the final consumer. This right of deduction of input tax through the supply chain with the exception of the final consumer ensures the neutrality of the tax towards factors like the nature of the product or the structure of the distribution chain.<sup>354</sup>

In the international context, double taxation with respect to VAT is usually avoided because of the destination principle: exports are exempt from tax, while imports are taxed on the same basis and at the same rate as domestic production. However, this principle is not uniformly implemented in different countries, which can sometimes lead to double taxation or unintended non-taxation.

The 1925 Report of experts to the League of Nations Fiscal Committee gave the following reason for dealing with “direct taxes” only:

We recognize ... the possibility of double taxation and evasion in the case of other kinds of taxes; but we have reached the conclusion, after consideration, that this matter should not be subject of any prolonged examination on our part. In the first place, the financial results of double taxation and evasion in this class of taxes are, in our opinion, very limited; in the second place, the differences and complexities of the various legislatures are far more accentuated in this sphere than in the sphere of direct taxes.<sup>355</sup>

However, at various stages throughout the history of international taxation, the inclusion of “indirect taxes” in tax treaties was taken into consideration. According to a 1931 Report of the League of Nations Fiscal Committee,

[a]t the General Meeting of Government experts held at Geneva in 1928, the point was raised whether measures designed to prevent double taxation should not also be extended to the turnover tax.... A first exchange of views on this problem took place in the Fiscal Committee, which considered that it presented a different aspect according to whether the turnover tax was levied directly on the income of the taxpayers or on the movement of goods or capital.<sup>356</sup>

The 1929 Report of the League of Nations Fiscal Committee to the Council contains the suggestion for a “study of the possibility of extending the measures designed to avoid double taxation to turnover tax, stamp duties and various charges in respect of international commerce.”<sup>357</sup>

The OEEC sustained efforts in this vein. In 1954, a Swiss Delegation submitted to the OEEC Council a note concerning double taxation in relation to indirect taxes and duties, asking the Council to study this issue in further detail, which was circulated among Members and non-Members for discussion.<sup>358</sup> The Delegate for Sweden noted that indirect taxes

did not generally give rise in the matter of double taxation to problems as grave as those raised by direct taxes.... [The Delegate for Sweden] nevertheless considers that a study which would help to clarify the situation might be useful, as it would show where there was double taxation with regard to indirect taxes and in what cases certain incomes were subject to double taxation in that they were subject to direct taxation in one country and in another country ... to an indirect tax.<sup>359</sup>

In a 1955 Proposal, Delegates from Switzerland, the Netherlands and Germany referred the matter to the Council:

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<sup>354</sup> See further OECD, International VAT/GST Guidelines (2006).

<sup>355</sup> League of Nations, Double Taxation and Tax Evasion, Report and Resolutions, Submitted by the Technical Experts to the Financial Committee of the League of Nations, Geneva, 7 February 1925 (F.212) Note to Part III of the Report.

<sup>356</sup> League of Nations, Fiscal Committee, Report to the Council on the Work of the Third Session of the Committee, held in Geneva from 29 May to 6 June 1931, C.415.M.171.1931.II.A, Chap. VII. (Double Taxation in regard to the Turnover Tax).

<sup>357</sup> League of Nations, Fiscal Committee, Report to the Council on the Work of the First Session of the Committee Geneva, 26 October 1929, C.516.M.175.1929.II, Chap. IV.

<sup>358</sup> The core statements of this document, circulated as C(54)331, are summarized in OEEC Council, Double Taxation and Tax Evasion, C/M(55)2 (Prov.).

<sup>359</sup> C/M(55)2 (Prov.) p. 21-22.



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It would also be of immediate practical interest to study these cases of double taxation which have not been settled by such agreements, particularly cases concerning indirect taxes, which have never been the subject of preparatory studies, either in the League of Nations, the United Nations or in other International Organisations.<sup>360</sup>

This was followed up by the 1955 Report of a group of fiscal experts, which also suggested the creation of a Fiscal Committee.<sup>361</sup>

With respect to indirect taxation, the experts noted:

The Group was also of the opinion that a study should be made of the problems of double taxation arising in the field of indirect taxes and, in particular, turnover taxes. The object of this study would be: (a) to examine cases where the same transaction is subject to turnover tax in several Member countries of the O.E.E.C., by reason of the differences between their fiscal systems, and the means by which this double taxation can be eliminated; (b) to determine whether and in which way it would be possible, with regard to services, to establish rules concerning turnover taxes which would lead to the elimination of double taxation.<sup>362</sup>

This Proposal was adopted, and the newly created Fiscal Committee was instructed, inter alia, to study:

In the field of direct taxation: ... Which taxes on income, capital, estates and inheritances should be included in Double Taxation Agreements; ... In the field of indirect taxation: (a) By which means can double taxation be avoided where the same transaction is subject to turnover tax in several Member countries; and (b) Whether and in which way can double imposition of turnover tax be avoided with regard to services.<sup>363</sup>

At the 17th Session of the OECD Fiscal Committee in 1964, WP No. 24 was set up “to study the question of international double taxation with respect to indirect taxes.” The WP stated that

[d]ouble taxation of two different kinds may arise in connection with indirect taxes on services: (a) Double taxation arising out of the concurrent levying of an indirect tax and an income tax on the same service. (b) Double taxation arising out of the levying of an indirect tax in more than one country on the same service.<sup>364</sup>

However, the WP noted from the outset that these problems are “limited in extent by the fact that in a number of Member countries taxes are either not levied on services at all or else are levied on only a few services.”<sup>365</sup> Work in the area of indirect taxation was eventually discontinued, also with a view to the fact that EEC Directives in this area were expected to be adopted by 1967.<sup>366</sup>

Moreover, VAT as well as customs duties and special excise taxes (e.g. taxes on petroleum, tobacco or alcohol) are dealt with in the framework of the GATT and WTO Agreements. Farrell noted that figuratively speaking, “adopting the assumption that customs duties fall under the concept of tax one may view the GATT as a multilateral indirect tax treaty.”<sup>367</sup> As VAT and similar taxes like sales taxes in the cross-border context are increasingly taxed in the country of destination, problems of double taxation are rare, which is why non-coverage in tax treaties can be seen to be warranted. Customs duties and VAT also come within the EU customs union; Art. 93 of the EC Treaty provides for the harmonization of “turnover taxes”, which has been effected by a number of EC Directives regarding

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<sup>360</sup> OEEC, Proposal by the Netherlands, Swiss and German Delegations concerning Double Taxation Questions to be discussed by a Group of Taxation Experts which should be set up within the O.E.E.C., 9 Paris December 1955, C(55)307, p. 2.

<sup>361</sup> OEEC Council, Report of the Ad Hoc Group of Experts on Fiscal Questions, 24 Paris February, 1955, C(56)49, m.no. 11: “The ad hoc Group of Experts therefore unanimously recommends to the Council that a specialist body on fiscal questions should be established within O.E.E.C. on a permanent basis.”

<sup>362</sup> Id., m.no. 6.

<sup>363</sup> OEEC, Council, Resolution of the Council Creating a Fiscal Committee, Paris, 19 March 1956, C(56)49(Final).

<sup>364</sup> OECD, WP No. 24 (Double Taxation with respect to Indirect Taxes) 1st Report on Double Indirect Taxation, FC/WP 24(66)1, m.no. 4.

<sup>365</sup> Id., m.no. 5.

<sup>366</sup> OECD, Fiscal Committee, Minutes of the 23rd Session held at the Château de la Muette, Paris, 10-13 May 1966; Paris, 10 June 1966, FC/M(66)1, Point VII. (Double Indirect Taxation) containing a statement of the Representative of the European Economic Commission.

<sup>367</sup> Farrell, “The Concept of Tax in the World Trade Organisation Agreements – A Brief Overview”, Paper for the 9th Annual EATLP Meeting on “The Concept of Tax” on 27-29 May 2005.

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VAT. All of these taxes, commonly classified as “indirect taxes”, can be seen to be outside of the scope of the OECD Model Conventions.

Nevertheless, hybrid forms of taxation may well have aspects which are direct and such that are indirect, which makes classification difficult. An interesting case in this context arose when Italy introduced a tax on regional productive activities in 1998; the “IRAP”<sup>368</sup> is a regional tax imposed on productive activities of manufacturing enterprises, professionals, non-residents and other entities, which replaced the Italian local income tax that is listed in Italian tax treaties. One of the features of the IRAP is that it is not based on a traditionally calculated taxable profit, but is closer to a turnover tax in that it is levied on each stage of production. The IRAP was accepted as a creditable tax under most tax treaties.<sup>369</sup> The new Italy–US tax treaty of 1999 (which is not yet in force) explicitly lists the IRAP as a covered tax.<sup>370</sup> The ECJ dealt with the question whether the IRAP was a prohibited turnover tax under the VAT Directives, a question that was answered in the affirmative in two Advocate-General Opinions.<sup>371</sup>

A decision to the effect that the IRAP is seen to be incompatible with the Community prohibition of national turnover taxes other than VAT would have led to claims by taxpayers in Italy’s treaty partners to reclaim IRAP (or similar taxes) previously credited as income taxes. Surprisingly, the ECJ decided contrary to the earlier A-G Opinions, holding that the IRAP does not contravene EC law.<sup>372</sup>

The express reference to “direct taxes” contained in the League of Nations Draft Model Conventions (see Annex I) was not endorsed in the 1957 Draft Conventions. The Italian Delegate comments that the first paragraph of the draft article “adopts ... the terms ‘taxes on income’ and ‘taxes on capital’, thus dispensing with the less precise term ‘direct taxes’.”<sup>373</sup> The current Model Commentaries contain a similar statement: “This paragraph defines the scope of application of the Convention: taxes on income and on capital; the term ‘direct taxes’ which is far too imprecise has therefore been avoided.”<sup>374</sup>

The distinction between “direct” and “indirect” taxes is quite old; John Stuart Mill wrote in 1948:

Taxes are either direct or indirect. A direct tax is one which is demanded from the very person who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intuition that he shall indemnify himself at the expense of another; such are the excise or customs.<sup>375</sup>

Such distinction, however, has been subject to criticism and different interpretive approaches in various contexts.<sup>376</sup> It features prominently in EC law and in world trade law, the latter giving definitions of “direct” and “indirect” taxes as used in the ASCM.<sup>377</sup> These definitions are applied in all

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<sup>368</sup> The regional tax on productive activities (*Imposta Regionale sulle Attività Produttive*) was introduced by Legislative Decree (*Decreto legislativo*) No. 446 of 15 December 1997. See Frei, “Die neue regionale Steuer IRAP” (in Italian), IWB No. 12/1998, pp. 433 et seq.; Gantz/Gramaccia, “Die Einführung der IRAP” (in Italian), SWI 2000, pp. 270 et seq.

<sup>369</sup> Cf. Pandolfini, “IRAP: The Regional Tax on Productive Activities – International Issues”, *European Taxation* 1999, pp. 249 et seq.

<sup>370</sup> Art. 2(b)iii of the Italy–US Convention for the Avoidance of Double taxation with respect to taxes on income and the Prevention of Fraud or Fiscal Evasion, concluded 25 August 1999, not yet effective. The Technical Explanation of the US Department of Treasury of 27 October 1999 states: “Subparagraph 2(b) specifies that the existing Italian covered taxes are the individual income tax; the corporation income tax; and that portion of the regional tax on productive activities (commonly known as IRAP) that is considered to be an income tax pursuant to paragraph 2(c) of Article 23 (Relief from Double Taxation) of the Convention.”

<sup>371</sup> Opinion of Attorney-General Jacobs, delivered on 17 March 2005; A-G Stix-Hackl issued her Opinion on 14 March 2006.

<sup>372</sup> C-475/03, *Banca popolare di Cremona Soc. coop. Arl v. Agenzia Entrate Ufficio Cremona*, Judgment of the Court of 3 October 2006. Moreover, the European Commission has found that the IRAP does not constitute prohibited state aid: Brussels, C(2006) State aid No 102/2006 Italy (Friuli -Venezia Giulia) – IRAP tax rate reduction – Regional Law 2/2006, art. 2.2.

<sup>373</sup> FC/WP 3(57)1, m.no. 4(a).

<sup>374</sup> Model Commentary on Art. 2(1) of the Income and Capital MC, m.no. 2.

<sup>375</sup> John Stuart Mill, *Principles of Political Economy*, Book V, Chap. 3 (“Of Direct Taxes”), first published 1848.

<sup>376</sup> For more on this typological distinction and its early criticism see Weyermann, “Direkte und Indirekte Steuern – Zur Begründung ihrer begrifflichen Unterscheidung”, in Fricke (ed.) *Finanzwirtschaft und Geschichte*, FA 1936/1937.

<sup>377</sup> Annex I of the ASCM, note 58, provides the following definitions: “The term ‘direct taxes’ shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property.... The term ‘indirect taxes’ shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges.”

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areas of world trade law.<sup>378</sup> Especially for purposes of EC law, the distinction as between these two categories of taxes has been difficult to draw.<sup>379</sup> Similar problems have arisen in domestic court cases outside of the European Community.<sup>380</sup> However, the “shifting of burdens” seen to be the defining factor of indirect taxation may, in principle, also occur in the context of direct taxation.<sup>381</sup> With a view to continuing difficulties attached to the delimitation between “direct” and “indirect” taxes, the elimination of reference to the notion of “direct taxes” in the Model Conventions was warranted.<sup>382</sup>

### 1.3. Interest and penalties

An important question to be answered in determining the substantive scope is whether the treaty applies not only to the principal amount of taxes due but also to incidental items that enable levying the principal tax. Until its 2000 version, the Income and Capital Model Commentary, on par with the Estates, Inheritances and Gifts MC, contained the following statement:

Clearly, a State possessing taxing powers – and it alone – may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that, in the levying of the tax, the accessory duties or charges depend on the same rule as the principal tax.<sup>383</sup>

Coverage under the treaty is thus in general provided for taxes that are incidental to the principal tax and levied according to the same rules. However, practice among contracting states has varied in this regard. An example is the Technical Explanation to the US–Australia tax treaty, which states: “The covered taxes do not include penalty or interest charges. For example, the ceiling rate of tax at source of 15 percent on dividends under Article 10 (Dividends) does not include any penalty or interest charge for late payment of tax.”<sup>384</sup>

New Zealand made the following observation to the 1977 OECD Commentary: “In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, New Zealand would wish to make it clear that the term ‘tax’ does not include penalties.”<sup>385</sup> This was to ensure that New Zealand grants credit only in the amount of the principal tax due in the other contracting state. New Zealand imposes penalties in the context of withholding taxes for late payment or non-compliance of fiscal requirements, which are regularly reciprocally exempted by the treaty partner.<sup>386</sup> In 1995, New Zealand added to its observation the exclusion from treaty coverage of interest on overpayment or

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<sup>378</sup> Schön, “World Trade Organization Law and Tax Law”, *Bulletin for International Fiscal Documentation* July 2004, p. 287.

<sup>379</sup> See ECJ, C-191/94, ECR 1995 at I-01859, para. 30, where the ECJ held with respect to the concept of tax in Art. 93 of the EC Treaty that “the charges in question could equally be regarded as direct or as indirect taxes.”

<sup>380</sup> See, e.g., the Supreme Court of Canada in *Canadian Industrial Gas and Oil Ltd. v. Government of Saskatchewan* (1978) 2 S.C.R. 545: “The dividing line between a direct and an indirect tax is referable to and ascertainable by the general tendencies of the tax and the common understanding of men as to those tendencies.... Certain well understood categories of taxation have been generally established as falling within one or other of these classes. The custom levies are recognized as being indirect taxes, whereas income and property taxes have been recognized as being direct taxes. A sales tax, imposed upon vendors of goods, has been generally regarded as an indirect tax. On the other hand, where the tax, although collected through the vendor is actually paid by the ultimate consumer, the tax has been held to be direct.”

<sup>381</sup> See the examples regarding taxes withheld at source as well as property taxes of a hired estate in Wassermeyer in Debatin/Wassermeyer, Commentary on Art. 2 para. 1, m.no. 13.

<sup>382</sup> See also M. Lang, BIFD 2005, p. 217, speaking of this decision to have been “a wise one”.

<sup>383</sup> 1977 Commentary on Art. 2 para. 2, m.no. 4. See also the identical wording in m.no. 4 of the 1963 version, as well as the 1982 Estates, Inheritances and Gifts MC Commentary on Art. 2 para. 2, m.no. 6., and m.no. 4 of the 1966 Estates and Inheritances MC Commentary.

<sup>384</sup> US Treasury Department Technical Explanation of the Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, effective 1 December 1983, Commentary to Art. 3, at Para. 6.

<sup>385</sup> 1977 Commentary on Art. 2 of the Income and Capital MC, m.no. 9.

<sup>386</sup> See, for example, Art. 3(2) of the 1982 New Zealand–US tax treaty: “In the Convention, the terms ‘New Zealand tax’ and ‘United States tax’ do not include any amount which represents a penalty or interest imposed under the law of either Contracting State relating to the taxes to which the Convention applies.”

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underpayment of tax.<sup>387</sup> The observation was eventually deleted, as the 2000 Income and Capital MC Commentary took a stand on the issue:

Clearly a State possessing taxing powers – and it alone – may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty. Practice among Member countries varies with respect to the treatment of interest and penalties. Some countries never treat such items as taxes covered by the Article. Others take the opposite approach, especially in cases where the additional charge is computed with reference to the amount of the underlying tax. Countries are free to clarify this point in their bilateral negotiations.<sup>388</sup>

Most income tax treaties concluded by the United States expressly provide that the accumulated earnings tax and the personal holding company tax are not covered.<sup>389</sup> The accumulated earnings tax is classified as a penalty tax under US law since it is incurred if a corporation accrues earnings without distributing their dividends to stockholders. This penalty tax is owed in addition to any income taxes due. The holding company tax is a penalty tax of 39.6% imposed in addition to the corporate tax on personal holding companies. This tax is applied to the corporate taxable income, less distributions to shareholders, income taxes and certain other adjustments. Taxes that have a penalty character or similar strong domestic policy functions will regularly not be covered under tax treaties; however, some treaties provide for limited or conditional coverage of penalty taxes.<sup>390</sup>

Arguably, for reasons of administrability and in the light of the broad coverage envisaged in Art. 2, interest and other charges incidental to the principal tax will regularly be covered. Monetary fines and penalties, albeit levied in respect of a principal tax, will often not be seen as merely incidental by the respective country due to their penalty character or for reasons of domestic tax policy. Conceptually, the non-coverage of penalty taxes does not necessarily mean that the foreign taxpayer who pays penalty taxes obtains no treaty relief: with respect to the US accumulated earnings tax and the personal holdings company tax, Larkins has noted that these penalty taxes arguably are indirectly reduced, since the starting point for calculating their respective tax bases is the person's taxable income, as reduced by tax treaties.

The concept of "tax" in tax treaties is thus broader than in the majority of domestic tax laws, where the notion of "tax" is limited to the principal amount due according to government tax legislation and does not extend to incidental charges. With regard to administrative fines and penalties accessory to the principal tax, the Commentary leaves the case for coverage open. Accessory duties, costs and interest for late filing of returns or late payment of tax can be seen to be within the substantive scope of the treaty unless the parties explicitly provide otherwise in the treaty or in a pertaining protocol.

During the drafting of the 1928 League of Nations Models, treaty coverage of accessory charges was seen to best conform to the agenda of preventing double taxation. Concerns were voiced only by the UK Technical Expert with respect to the provision on income from shares or similar interests: "In the view of the British expert it is unreasonable that the financial burden of granting relief from double taxation in respect of the additional tax on dividends should also fall on the State of domicile."<sup>391</sup> It can indeed be argued that jurisdiction to impose tax under the treaty should not entail the right to impose penalties and interest for non-payment of the tax; however, this is for the treaty partners to agree upon during negotiations.

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<sup>387</sup> Commentary on Art. 2, m.no. 9, as amended on 21 September 1995, to state: "In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, New Zealand would wish to make it clear that the term 'tax' does not include penalties, or interest on overpayment or underpayment of tax."

<sup>388</sup> 2000 Commentary on Art. 2 para. 2, m.no. 4; identical with the 2005 version, m.no. 4.

<sup>389</sup> Ernest R. Larkins, "U.S. Income Tax Treaties in Research and Planning: A Primer", 18 *Virginia Tax Review* 1998, p. 133.

<sup>390</sup> See, e.g. m.no. 2 (b) of the Protocol to the US-Portugal Income Tax Treaty (concluded 6 September 1994, effective 1 January 1996).

<sup>391</sup> Comment by Sir Percy Thompson, Deputy Chairman of the UK Board of Inland Revenue, on Art. 4 of the 1927 Draft of a Bilateral Convention for the Prevention of Double Taxation, in: League of Nations, Double Taxation and Tax Evasion, Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Geneva, April 1927 (C.216.M.85.1927.II) under B.I.

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The 1957 Commentary by the Italian Delegate of WP No. 30 contains the following clarifying statement:

It seems clear that the proposal in the second paragraph of the draft implies that the term 'tax' should comprise not only the principal duty of tax but also all surcharges, interest, costs and all other additional duties of an accessory nature. As regards surcharges and money penalties, it is obvious that, like the taxes themselves, they are imposed by act of the taxing authority, an act which, in both cases, has the same legal character both as regards form and substance. As regards interest, costs, etc., these attach to the tax as an accessory attaches to its principal, and receive the same treatment.<sup>392</sup>

On the other hand, payments of predominantly punitive character are not intended to come within treaty relief.<sup>393</sup> Across nations, taxes are generally distinguished from payments that are meant as punishment for unlawful acts.<sup>394</sup> Moreover, the assessment of taxes is regularly separated from the assessment of penalties, since most countries have codified a right not to declare against oneself.

The OECD "Classification of Taxes and Interpretative Guide", attached as an Annex to the OECD Revenue Statistics, states: "The term 'tax' does not include fines unrelated to tax offences and compulsory loans paid to government."<sup>395</sup> It may sometimes be unclear whether the main idea of the charge is not punishment but rather the raising of revenue. However, the assessment of taxes will in principle be separate from the assessment of penalties: while taxes are designed to produce revenue, penalties are aimed at deterring undesired taxpayer behaviour or to effect punishment; impositions of the latter character are generally outside the scope of tax treaties that follow the OECD Model texts.

#### 1.4. Payments "on behalf of" the state

Art. 2(1) of the OECD Models stipulates that the treaty applies to taxes "imposed on behalf of a Contracting State or of its political subdivisions or local authorities". The formulation "on behalf of" is also used in the context of attribution of income under the OECD Income and Capital MC.<sup>396</sup> The Commentary on Art. 18, dealing with the allocation of remuneration "paid by, or on behalf of" the employer, states: "The phrase 'made by or on behalf of' is intended to apply to contributions that are made directly by the individual as well as to those that are made for that individual's benefit by an employer or another party...."<sup>397</sup> The focal point in the context of imposition "on behalf of" a state appears to be whether, from an economic rather than a formal perspective, the payments effectively accrue to the state.

The 1925 Report submitted by the Technical Experts to the Financial Committee of the League of Nations speaks to this precept in describing taxation "at the source" as the assessment of the tax and not the method of its collection. The experts noted: "In Great Britain, as on the Continent, certain taxes are collected on behalf of the Treasury by a third party – for instance, the company which pays a dividend or interest on stock. In both cases, the tax is 'collected at the source'".<sup>398</sup> Where a levy

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<sup>392</sup> FC/WP 3(57)1, p. 9, under 5.

<sup>393</sup> See also K. Vogel, Commentary on Art. 2 para. 2, m.no. 28.

<sup>394</sup> Cf. the definition of "tax" in Larkins (ed.) *International Tax Glossary*, stating that taxes are generally "not imposed by way of fine or penalty (e.g. for non-compliance with the law)." This approach is mirrored in court cases worldwide; see e.g. the US Supreme Court in *United States v. La Franca*, 282 U.S. 568 (1931) 282 U.S., at 568: "A 'tax' is an enforced contribution to provide for the support of government; a 'penalty', as the word is here used, is an exaction imposed by statute as punishment for an unlawful act. The exaction here in question is not a true tax, but a penalty involving the idea of punishment."

<sup>395</sup> See m.no. 2 in OECD, *The OECD Classification of Taxes and Interpretative Guide* (2004).

<sup>396</sup> See Art. 5(5), Art. 15(1)(b), and Arts. 26 and 27, as well as the Commentary to Art. 18. For an insightful discussion of mentioned area, see Wheeler, "The Attribution of Income to a Person for Tax Treaty Purposes", *Bulletin for International Fiscal Documentation* 2005, pp. 477 et seq.

<sup>397</sup> Commentary on Art. 18, m.no. 49, last sentence. Cf. also the Commentary on Art. 5 para. 4, m.no. 22, speaking of "a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise."

<sup>398</sup> League of Nations, *Double Taxation and Tax Evasion – Report and Resolutions*, Geneva, 7 February 1925, under Heading 4. Comments on the Resolutions.

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accrues to the treasury of a country, irrespective of whether collection is “outsourced” to a third party, it is thus deemed levied on behalf of that country.

Economic accrual in the sense of revenue can however not be the sole determinative factor; the payments must come within the purview of the sovereign powers of government. In order to serve government’s behalf, full discretion and control over the spending of the revenues is essential. Where government authorities serve only in an assessment and/or collection and enforcement capacity while the payments effectively accrue to agencies outside of government sovereignty, the payment cannot be considered a tax covered under tax treaties. Conversely, where government avails itself of private bodies that are under its control in the assessment and/or collection of a certain payment, this payment is levied according to governmental fiscal sovereignty and has the character of a tax. The same is true if government uses its sovereign power to earmark the tax for a special purpose, even if it aims to benefit non-governmental institutions serving public purposes.

This differentiation will bring clarity in most cases, but sometimes, specification is necessary – e.g. where it is questionable whether church taxes levied in numerous European countries come within the treaty scope.<sup>399</sup> While it is a constitutional principle in some countries, e.g. the United States, that state resources may never be allocated to religious communities, some European states, e.g. Norway and Greece, finance the church exclusively out of general taxation. In Italy, Spain and Hungary, a surcharge on the general income tax is earmarked for cultural purposes, including the church.

In order to be covered under Art. 2 of the OECD Models, payments must be levied “on behalf of a State or its political subdivisions or local authorities”; therefore, church taxes are outside the treaty scope where they accrue to institutions that are different in nature from governmental political subdivisions or local authorities and independent of government authority in the spending of their accrual.<sup>400</sup>

Even if the collecting and enforcement mechanism of government is used to levy such payments, as is the case in Germany, they do not have the character of taxes coming under the substantive scope of tax treaties, as the church bodies are autonomous in the spending of the accrual. However, in some cases, autonomous non-governmental spending power is not enough to ascertain non-coverage: tax treaties concluded by Denmark, Finland and Sweden regularly include church taxes in their list of taxes covered; so does the Nordic Convention.<sup>401</sup> Moreover, Switzerland has sometimes agreed to coverage of Swiss church taxes with its treaty partner.<sup>402</sup> In said countries, church communities decide autonomously on the spending of their revenues. An interesting commonality with general taxation is that church taxes are levied not only on natural persons, but equally on juridical persons.<sup>403</sup>

The key to recognition that the payment may come within tax treaty scope seems to be the fact that the church authorities in these countries perform tasks serving the public as a whole like registration of the population; the costs thus incurred will often be covered to some extent by general taxation. While church authorities do have autonomous spending power over revenue from church taxes, there is considerable de facto government influence over the spending. Such influence, in and of itself, however, would not be sufficient to consider the payments to have been made “on behalf of” government authorities. Where non-governmental authorities consistently perform considerable tasks

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<sup>399</sup> See also Thuronyi, *Comparative Tax Law*, Kluwer Law International (2003) pp. 129 et seq.

<sup>400</sup> Such is the case, for example, with church taxes in Austria.

<sup>401</sup> Art. 2(3) of the Nordic Convention on Income and Capital of 23 September 1996, effective 1 January 1998. For more insight, see Helminen, “Scope and Interpretation of the Nordic Multilateral Double Taxation Convention”, *Bulletin for International Taxation* 2007, pp. 23 et seq.

<sup>402</sup> Agreement between Switzerland and Germany, released by the German Ministry of Finance on 23 February 1987, with respect to the Germany–Switzerland Income and Capital tax treaty of 11 August 1971, effective 1 January 1972; the agreement was released by the German Ministry of Finance on 23 February 1987. The agreement provides for coverage of Swiss church taxes as regular local taxes under the treaty.

<sup>403</sup> For Finland, see Heikkilä/Knuutila/Scheinin, “State and Church in Finland”, *European Journal for Church and State Research* 1995, Vol. 2, pp. 115 et seq. For Switzerland, see Höhn/Waldburger, *Steuerrecht Band I*, 8th edn. (1997) p. 135.

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with respect to the public at large on behalf of government authorities, treaty coverage is in line with the object and purpose of the treaty to provide protection.

Therefore, albeit not placed into the state's general fund, payments to non-governmental authorities that primarily perform administrative functions benefiting the general public, may be seen to be taxes covered under the treaty – unless there is genuine independence from government authority as to how the funds are used. This basic finding also has practical relevance in the case of social security payments, which are dealt with separately and in more detail below.

### 1.5. Local taxes

Art. 2(1) of the OECD Models makes clear that the taxes covered are “imposed on behalf of a Contracting State or of its political subdivisions or local authorities.” The Model Commentary on Art. 2 states:

It is immaterial on behalf of which authorities such taxes are imposed; it may be the State itself or its political subdivisions or local authorities (constituent States, regions, provinces, ‘départements’, cantons, districts, ‘arrondissements’, ‘Kreise’, municipalities or groups of municipalities, etc.).<sup>404</sup>

Such extension of the taxing power has featured in tax treaty practice since the very beginning. The Commentary to the 1928 Model Convention of the League of Nations states: “Taxation levied on behalf of subordinate public bodies (provinces, cantons or departments, municipalities, etc.) may be included in the list, if circumstances justify such a measure.”<sup>405</sup>

Speaking of the description of the public authorities imposing the taxes as an “undoubted merit”, the Italian Delegate of OEEC WP No. 3 refers to the fact that “[i]t certainly answers ... the need to determine as clearly and as fully as possible the fiscal relations of the citizens of the contracting States with all the fiscal authorities of such States.” Nevertheless, the Delegate also notes:

It cannot be overlooked that often, under the internal laws and, sometimes, under the Constitutions of the various States, there are smaller political sub-divisions and certain local authorities which have autonomous taxing power, and that the contracting State (the largest political unit, whether it is constituted by a unitary State, a Federation or a Confederation) is sometimes not empowered to represent the smaller bodies or to restrict their sphere of taxation. However, it has been considered useful to lay down a general principle to which each State will be able to conform, depending on its internal law or Constitution.<sup>406</sup>

The OECD Model Conventions thus do not aim to differentiate between central or decentralized levels of government. Impositions of federal as well as local and provincial government authorities are covered, including all geographical extensions of government authority as well as legal entities that function as political subdivisions of the state.<sup>407</sup>

Under the US Model Convention, only taxes levied at federal level are covered.<sup>408</sup> Except with respect to the provision on non-discrimination, US state and local taxes are not covered by the Convention.<sup>409</sup> From the very outset in the drafting of the OECD Income and Capital MC, the United States as well as Canada have made reservations to this effect. The Report of WP No. 30, under the heading “Taxes of political subdivisions or local authorities (local taxes)”, provides an insight:

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<sup>404</sup> Model Commentary on Art. 2 para. 1, m.no. 2 of the 2005 Income and Capital MC Commentary; m.no. 4 in the 1982 Estates, Inheritances and Gifts MC Commentary.

<sup>405</sup> League of Nations, Double Taxation and Tax Evasion, Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, Geneva, October 1928, Commentary on Art. 1 of Draft Convention No. 1a.

<sup>406</sup> FC/WP 3(57)1, Commentary by the Italian Delegate, m.no. 4 (e) at p. 8.

<sup>407</sup> See also M. Lang, *Bulletin for International Fiscal Documentation* 2005, p. 217.

<sup>408</sup> There is sometimes interaction of US state laws with tax treaties in that the tax base in many US states is the adjusted taxable income under federal law; see thereto also Larkins, “US Income tax Treaties in Research and Planning”, 18 *Va. Tax Rev.* 1998, pp. 133 et seq.

<sup>409</sup> Cf. the Technical Explanation to Art. 2(1)(a) of the 1996 the US Model Income Tax Treaty.

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Under the federal system operative in the United States, the governments of the individual states (and municipalities) have separate tax powers not derived from the national government. Although the national government has over-riding authority with respect to foreign commerce, the impact, if any, of state income taxes upon foreign commerce is very limited. It has therefore been customary for the United States to exclude the state tax systems from the scope of its income tax treaties.<sup>410</sup>

The question arises whether such explicit limitation of treaty coverage to taxes levied at federal level in the United States and Canada affects also local taxes levied in the other contracting state. WP No. 30 recognized this as a major issue in the application of treaties; as no materials have since considered the issue in equal depth, the full account is provided in the following:

The reserves of Canada and the United States put forward the question whether the contracting partners of these states should also exclude their local taxes from the scope of the Convention. The OECD Commentary on Article 2 says in paragraph 1 that the Article intends to widen as much as possible the field of application of the Convention by including as far as possible and in harmony with the internal legislation of the Contracting States the taxes imposed by political sub-divisions or local authorities of the Contracting States. Starting from this philosophy standing behind Article 2 and underlying the whole Convention, it seems to be preferable that at least the one State (for whom it is possible and in harmony with its internal legislation) should include his local taxes in the scope of the Convention.

However, starting from practice rather than from theory, the fact should not be neglected that a Convention for the avoidance of double taxation obliges both Contracting States to give up certain taxation rights; but such obligation should be based on the principle of reciprocity, i.e. there should be a fair and equitable balance in renunciation on taxation rights between both Contracting States. From that angle an exclusion of local taxes could be justified. But since a decision in this matter depends on so many special circumstances (e.g. the ratio), it should be left free for bilateral negotiations.<sup>411</sup>

Usually, no conclusive statements on this issue are to be found in treaties or protocols. Some treaties explicitly apply to political subdivisions, but not to local authorities,<sup>412</sup> while others mention solely the state or its local authorities.<sup>413</sup> Nevertheless, treaty practice has shown that taxes levied on behalf of local authorities will regularly be covered on the part of most European countries. Local or municipal taxes are sometimes explicitly included in the exhaustive list of taxes covered. An example is the Income and Capital Tax Treaty between the United States and Germany, which lists, among the German taxes that are exhaustively covered, the *Gewerbesteuer* (trade tax) levied on behalf of German municipalities.<sup>414</sup> Initially introduced as a fee-type addition to the German land tax (*Grundsteuer*) in 1895, the *Gewerbesteuer* has been a major revenue source at municipal level<sup>415</sup> since 1936 and is now regularly listed in treaties concluded by Germany.

## 1.6. “Ordinary” and “extraordinary” taxes

The Income and Capital MC Commentary on Art. 2(2) comments on the coverage of “ordinary” and “extraordinary” taxes in the following manner:

The Article does not mention ‘ordinary taxes’ or ‘extraordinary taxes’. Normally, it might be considered justifiable to include extraordinary taxes in a model convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

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<sup>410</sup> FC/WP 30 (69) 1, m.no. 22 on p. 9.

<sup>411</sup> Id., m.nos. 23 through 25.

<sup>412</sup> See, e.g. Art. 2(1) of the Belarus–South Africa Income and Capital Tax Treaty of 2002, effective 1 January 2004.

<sup>413</sup> See Art. 2(1) of the Azerbaijan–China Income Tax Treaty of 2005, effective 1 January 2006.

<sup>414</sup> Germany–US Income and Capital Tax Treaty (1989, as amended through 2006), Art. 2(1)(b)(cc).

<sup>415</sup> W. Ritter et al., “Verfassungskonforme Reform der Gewerbesteuer”, BDI (2001) 7.



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As Lang<sup>416</sup> has noted, the position taken in the Commentary seems confusing: on the one hand, the parties may “restrict” the treaty scope to ordinary taxes while on the other they may “extend” it to extraordinary taxes. The first statement suggests that extraordinary taxes will be covered unless explicitly excluded by the parties; the second statement seemingly indicates that special provision is necessary on the part of the contracting states to draw extraordinary taxes within treaty scope.

The Commentary of the Swiss Delegate to WP No. 3 to para. 1 of the 1957 Draft Art. 2 on income and capital, as well as on estates and inheritances (see Annex I) explains:

Paragraph 1 defines the object of the Convention and its general field of application. The latter embraces extraordinary taxes in addition to ordinary taxes. In view of the Delegate for Switzerland, this is reasonable, for double taxation Conventions should put an end to all, and not just a few, cases of double taxation, irrespective of the nature of the taxes, the authority imposing them, the method of collection, or the prevailing circumstances (e.g. peace or war). Moreover, the need to prevent double taxation is increasingly felt in the case of extraordinary taxes, because these are in general particularly heavy charges imposed in exceptional circumstances. This view is also justified by the fact that Conventions are concluded for the benefit not of the taxation authorities, but of the taxpayers. Finally, to exclude certain categories of taxes from a Convention’s field of application would largely frustrate the Convention, for in that case each State would be at liberty to decide unilaterally that a particular tax was an extraordinary tax and thus restrict arbitrarily the concessions agreed upon.<sup>417</sup>

It becomes clear that “extraordinary taxes” means any taxes levied under special circumstances, whichever characteristic renders them out of the ordinary; they may be of temporary character, levied at special rates, or on special items. From the purpose expressed also in the present paras. 1 and 2 of Art. 2, and with a view to the possibility of a state “arbitrarily restricting the concessions” of the treaty, it seems indeed prudent to generally regard exceptional taxes as being covered.<sup>418</sup> However, especially as regards taxes of merely temporary character, a state might argue that coverage was not intended.

The indecisive statements in the present Commentary can be traced back to differing views of the Members of the OEEC Fiscal Committee, as evidenced in the Minutes of a 1957 Session of the OEEC Fiscal Committee, where the suggestions of the Swiss Delegate of WP No. 3 came under scrutiny:

A general discussion ensued on whether extraordinary taxes on income and capital should be provided for in the draft Convention, as proposed by the *Delegate for Switzerland*. The *Delegates for Italy, Denmark and Belgium* were in favour of excluding these taxes from the draft Convention, which would leave open the possibility of settling the matter through bilateral Conventions. The *Delegate for Germany* considered that if it was not possible to include all extraordinary taxes they should nevertheless not all be excluded, and that the question should be dealt with in the comments.... The *Delegate for the United Kingdom* thought it preferable that extraordinary taxes should be neither included nor excluded formally. The *Delegate for France* considered that directives should be established on the treatment of extraordinary taxes.... The Committee decided not to mention extraordinary taxes in the Draft Convention. It asked the Working Party to put the reasons for this decision in its comments and to indicate that it was open to Member countries to apply to extraordinary taxes the principles laid down for the other taxes.<sup>419</sup>

The subsequently adopted Commentary to the 1957 Draft Convention contains the identical wording of today’s Model Commentary, with the reasons for not mentioning “extraordinary taxes” reflecting the inconclusive outcome of the preceding discussions.<sup>420</sup> So does the 1969 Report of WP No. 30; WP No. 30 merely adds the statement that several Conventions “contain – in accordance with the O.E.C.D. Commentary – a specific reference to ‘extraordinary taxes’”. There seems to be no practical need for a change of this concept.<sup>421</sup>

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<sup>416</sup> M. Lang, *Bulletin for International Fiscal Documentation* 2005, p. 217.

<sup>417</sup> FC/WP 3(57)1, Commentary by the Delegate for Switzerland, p. 14.

<sup>418</sup> See also Büge in Becker/Höppner et al. (eds) *Commentary on Art. 2 para. 1, m.no. 16*, stating that extraordinary taxes are covered under the broad descriptions in Paras. 1 and 2 as well as under Art. 2(4).

<sup>419</sup> OEEC, Fiscal Committee, Minutes of the 3rd Session held at the Château de la Muette, 23-25 January 1957, FC/M (57)1, under Point III (emphasis in the original).

<sup>420</sup> Fiscal Committee, Listing and Definition of Taxes on Income and Capital, including Taxes on Estates and Inheritances, which should be covered by Double Taxation Agreements, FC(57)1, Point II. (Commentary on the Draft Article) m.no. 8.

<sup>421</sup> FC/WP 30(69)1, m.no. 31.

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It appears that there is at least consensus in that specific bilateral agreement may be necessary, depending on the specific details of the tax at issue and what can be expected in good faith by each of the treaty partners in balancing compromise as between their respective tax systems. In a similar approach, reference to “taxes of an exceptional nature” was first made in the Commentary to Art. 12 of the 1927 League of Nations Draft of a Bilateral Convention for the Prevention of Double Taxation:<sup>422</sup> “As regards taxes of an exceptional nature, special agreements may have to be concluded, having due regard to the nature of these taxes.”<sup>423</sup>

Although the issue cannot be resolved from the drafting history of Art. 2, the Model text is clearly indifferent to specific peculiarities of the tax; so long as it bears characteristic features of a “tax” and is levied on income and capital or estates, inheritances and gifts, the tax will be covered. Neither does the Model Commentary give chapter for a distinction between “ordinary” and “extraordinary” taxes.

If the parties have adopted the broad descriptions in Art. 2(1) and (2), and not made provisions with regard to peculiarities in their respective tax systems, broad coverage should be presumed in accordance with the object and purpose of the treaty. This approach can be seen to find a showcase in a domestic decision concerning the coverage of the Swedish temporary tax on profit distributions under Swedish treaties on income and capital, where the Swedish Supreme Administrative Court considered the coverage of the Swedish temporary tax on profit distributions as an extraordinary national income tax in the sense of the provisions corresponding to paras. 1 and 2 of Art. 2 in Swedish tax treaties.<sup>424</sup> The fact that a tax is of “extraordinary” character does not per se preclude it from qualification as a “tax on income and capital” or a “tax on estates, inheritances, and gifts.”

### 1.7. Earmarked taxes

As opposed to extraordinary taxes, earmarked taxes are not taxes imposed under special circumstances or on special incidents, but they are ordinary taxes earmarked for – meaning “set aside for” – a special purpose. There is no indication in the Model texts that the state or its political subdivisions or local authorities are barred from assigning a specific use to the revenue of a tax.

The 1969 Report of WP No. 30 took a stand on this issue in response to an inquiry of the US Delegate:

*The United States* raised the question whether the earmarking of taxes for particular purposes should be permitted to have any effect on their treatment in relation to double taxation Conventions.... The only decisive fact for the application of the Convention to a given tax is that the basis on which the tax is levied is considered to be ‘income (capital)’. But it is immaterial for which *purpose* this tax is collected. A tax the yield of which is allocated exclusively to earmarked funds, but the basis of which is ‘income’, must therefore be classified as ‘tax on income’ in the meaning of paragraphs 1 and 2 of the O.E.C.D.-Draft.<sup>425</sup> (emphasis in original)

The WP further illustrates this by way of example of an Austrian tax:

Austria has introduced in 1966 a tax which is called ‘Contribution on income to the emergency-fund’. The basis of the tax is the same as for the general income tax; the yield of the tax is allocated exclusively to a special fund which was created for the repair and prevention of emergencies caused by natural catastrophies. Since the basis of that Contribution is the ‘income’ of the taxpayer the contribution was considered to be an ‘income tax’, and because Austria regularly adopts a provision like paragraphs 1 and 2 of the O.E.C.D. Draft, there was no doubt that

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<sup>422</sup> The text of Art. 12 (“Miscellaneous Provisions”) is as follows: “The principles laid down in the preceding articles shall be applicable mutatis mutandis, to the recurrent taxes on total wealth, capital, or increments of total wealth, according as these taxes are impersonal or personal.”

<sup>423</sup> League of Nations, Double Taxation and Tax Evasion, Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Geneva, April 1927 (C.216.M.85.1927.II) Point B. An identical statement is found in the Commentary on Art. 12 of the 1928 Draft Convention No. 1a.

<sup>424</sup> Swedish Supreme Administrative Court, Case No. 5823-1985, decision of 3 June 1986.

<sup>425</sup> FC/WP 30 (69)1, m.no. 17.

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this Contribution – although it was earmarked – comes under the double taxation conventions concluded by Austria; respective notifications were submitted by Austria to the other Contracting States.<sup>426</sup>

This interpretation goes in line with the general purpose of Art. 2 to broaden as much as possible the scope of the Convention. WP No. 30 stresses in this context<sup>427</sup> that difficulties with respect to the coverage of earmarked taxes will arise only in the case of an exhaustive list that does not contain taxes that are earmarked for special purposes. Payments funding social security are often levied in the form of earmarked taxation; their coverage under tax treaties can thus be controversial.

### 1.8. Social security charges

An intricate interrelation exists between taxation and social security not only in domestic tax systems but also in the international context. Social security payments are a major revenue source as well as a core element of fiscal policy in many countries.<sup>428</sup> Even countries that do not separately impose social security payments will regularly incur social security expenditure.<sup>429</sup> Where social security payments are income related rather than risk related, they could be seen as a regular income tax.

From the foregoing considerations, it is clear that social security contributions that are voluntary<sup>430</sup> or not payable to general government or a government-controlled agency do not come within the concept of “tax”. However, social security charges regularly have compulsory character; moreover, they help to achieve a more equitable income distribution and are often administered by revenue authorities. The *IBFD International Tax Glossary*<sup>431</sup> postulates that the term tax “may include social security contributions since they are compulsory.”

The OECD Revenue Statistics<sup>432</sup> define taxes as compulsory general payments for public purposes, including social security contributions. They are included in the total tax revenue because, like taxes, they can have an impact on the distribution of income.<sup>433</sup> But even in this context, conceptual differences are pointed out:

Compulsory social security contributions,... paid to general government, are treated here as tax revenues. Being compulsory payments to general government they clearly resemble taxes. They may, however, differ from other taxes in that the receipt of social security benefits depends, in most countries, upon appropriate contributions having been made, although the size of the benefits is not necessarily related to the amount of the contributions.<sup>434</sup>

In the practical application of tax treaties, the issue of differentiating between taxes and social security payments does arise. The question whether – and if so, under what circumstances – social security payments come within the substantive scope of tax treaties is largely unresolved.<sup>435</sup>

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<sup>426</sup> Id.

<sup>427</sup> Id., m.no. 16.

<sup>428</sup> Cf. the publications on the features of social security programmes in more than 170 countries downloadable from the official website of the US Social Security Administration. See also Pieters, “Reflections on the Methodology of Social Security Law Comparison”, in Ruland et al. (eds.) *Verfassung, Theorie und Praxis des Sozialstaats, liber amicorum Hans F. Zacher* (1998) p. 715.

<sup>429</sup> Larger countries that do not have social security levies include China, Australia, Indonesia and Thailand.

<sup>430</sup> An example is Peru, where the individual can choose between the governmental social insurance scheme and private schemes. In some countries, the system of social security payments is mixed, with some payments being compulsory and others voluntary; in Germany, for example, social security coverage of the self-employed is sometimes voluntary. In the UK as well as in Ireland, contributions are required from certain parts of the population, but those not required to pay may voluntarily enter the system and contribute.

<sup>431</sup> Larking (ed.) 4th edn. (2001).

<sup>432</sup> OECD, Revenue Statistics 1965-2005 (2006) pp. 17 and 285.

<sup>433</sup> See the criticism in Albada, “Social Security and Taxation: A Note on Some Intellectual Foundations of Social Security and Taxation”, 10 EJLE (2000) p. 123: “Calculating the burden of the cost of operation of the state, taxation and social security levies are simply added together. With this development the ideology behind social security as a separate financial system within the nation is disappearing.”

<sup>434</sup> OECD, Revenue Statistics 1965-2005 (2006) Annex A, The OECD Classification of Taxes and Interpretative Guide, m.no. 7.

<sup>435</sup> The first international expert conference ever to explore the relationship between tax treaties and international social security law was held in Austria from 7-10 July 2005, as part of a series of High-Level Scientific Conferences supported by the European

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While international social security law is governed by principles and objectives which are different from those predominant in international tax law,<sup>436</sup> both areas intersect where persons are liable to taxes in one state, but work in another state, where they pay social security contributions. There is a global network of bilateral social security agreements; they are sometimes also called “totalization agreements”, which indicates their function: on the one hand, such agreements aim to relieve double imposition of social security payments on the same income, by establishing that only the country in which someone is working may levy such payments; on the other hand, they provide for a “totalization” of benefits, so that an individual who made payments in both countries but has not accumulated enough coverage to be entitled to benefits in either of them may still qualify for benefits. Social security agreements usually do not expressly apply to “social security contributions” but rather to certain areas of “social security legislation” in the contracting states, usually comprising both payments and possible benefits.

As regards EC Member States and Members to the European Economic Area, these agreements are superseded<sup>437</sup> by Council Regulation No. 1408/71.<sup>438</sup> Similar to existing bilateral agreements, this Regulation coordinates the social security levies and benefits of Member States to substantiate the free movement of workers. In 2003, the scope of Reg. 1408/71 was extended to cover third country nationals legally resident in the territory of a Member State.

The guiding principle underlying bilateral agreements as well as the EC Regulation coordinating domestic social security legislation is that the country to which the coordination rules point will be the sole one entitled to impose social security contributions, irrespective of either domestic law or tax treaty rules. As social security systems across the nations are increasingly financed at least in part out of general taxation, the lines between social security contributions and taxes are oftentimes blurred. This is aggravated by the fact that the true nature of charges used for social security does not always equate to the “labels” used to describe them in domestic tax laws.<sup>439</sup> Moreover, countries have adopted techniques on the borderline between contributions and taxes so that it is complicated to distinguish between them.<sup>440</sup>

Compartmentalized thinking as to the areas of international tax law and international social security law should therefore be avoided, as the interplay of these areas needs to be taken into consideration when determining the scope of tax treaties. Sometimes, treaties explicitly exclude social security levies in the treaty text or protocol.<sup>441</sup> Since 1981, the US Model Income Tax Treaty has clarified that “social security” taxes levied under the Internal Revenue Code are excluded from treaty scope.<sup>442</sup> Most treaties adopting the OECD Model text are silent on the issue; only rarely are social security

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Commission. The National Reports from nearly all EC Member States, as well as Israel, New Zealand, Russia and the US, are published in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006).

<sup>436</sup> See K. Vogel, “Internationales Sozialrecht und Internationales Steuerrecht im Vergleich”, in Ruland et al. (eds.) *Verfassung, Theorie und Praxis des Sozialstaats, liber amicorum Hans F. Zacher*, p. 1173 (1174).

<sup>437</sup> Individuals may still rely on more favourable clauses of a SSA if they were effective before entry into force of Reg. 1408/71 resp. before accession to the EC. For more insight, see van Thiel, “Income Tax Payments and social security contributions from a Community law point of view: How the European Court of Justice could streamline its approach in the interest of the internal market”, in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006) pp. 37 et seq.

<sup>438</sup> EC, Regulation 1408/71 of 14 June 1971 on the Application of Social Security Schemes to Employed Persons and their Families Moving within the Community, O.J. 1971 (II) No. L 149, p. 2, 5 July 1971(original reference); OJ No. L 28, p. 1, 30 January 1997 (reprinted). The Regulation was adopted on the basis of Art. 235 of the EC Treaty (now Art 308 EC) and has been amended frequently since adoption: Regulation No. 883/2004 of the European Parliament and of the Council of 29 April 2004 on the Coordination of Social Security Systems, O.J. L (2004) p. 166; Proposal of 31 January 2006 for a Regulation of the European Parliament and of the Council laying down the procedure for implementing Regulation 883/2004, COM(2006)16.

<sup>439</sup> Pieters, “Social Security, Taxation, and European Integration”, in Berghman et al. (eds.) *Social Security Taxation and Europe* (1993) p. 235 (239).

<sup>440</sup> Mouton, “Methods of Financing Social Security in Industrial Countries: An International Analysis”, in International Labour Office, *Financing Social Security: The Options* (1984) p. 3 (29).

<sup>441</sup> See e.g. the Germany–Spain income and capital tax treaty of 1966, which, in Art 2(3) expressly excludes “social security premiums”. Another example is point I. of the Additional Protocol to the Sweden–Ukraine treaty of 1995.

<sup>442</sup> See Art. 2(1a) of the US Model Income Tax Convention of 20 September 1996. See also Art. 2(3b) of the 2006 US Model Income Tax Convention of 15 November 2006, not yet in force.

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levies included in the equivalent of the listing of taxes in Art. 2(3) of the OECD Model.<sup>443</sup> Nevertheless, as has been established in Part I of the thesis, the descriptions in paras. 1 and 2 have independent meaning for purposes of the taxes covered: a levy not contained in the listing might still be within treaty scope, so long as it comes under the general definition of “taxes on income and capital”.<sup>444</sup>

Social security payments throughout nations are levied either on taxable income or on a payroll basis. The Model Commentary states with regard to the general description in Art. 2(2): “[T]he definition extends to taxes on the total amounts of wages or salaries paid by undertakings (‘payroll taxes’; in Germany, ‘Lohnsummensteuer’; in France, ‘taxe sur les salaires’).”<sup>445</sup>

Therefore, as regards treaties that contain a general description along the lines of the OECD Model, in the absence of an express exclusion of social security charges from treaty scope in the treaty or pertaining protocol they may in principle be subject to treaty protection. However, an exhaustive listing of “the income tax” of a treaty partner leaves uncertainty where social security is financed even in part by way of general taxation.

The OECD Model Commentary refers to social security levies only at one point, with regard to “taxes on the total amount of wages”, stating that “[s]ocial security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as ‘taxes on the total amount of wages’.”<sup>446</sup> The sentence was added in the 1977 version of the Commentary to clarify the foregoing sentence, which postulates that “taxes on the total amounts of wages or salaries paid by undertakings” are to be considered taxes on income and capital in the sense of Art 2. It is not expressly stated that social security charges are not “taxes on income and capital”. More of an insight can be gleaned from the statements of WP No. 30, considering the deletion of the formulation “taxes on the total amounts of wages or salaries paid by enterprises”, following a notification of the Austrian Delegate.<sup>447</sup>

WP No. 30 comments:

In theory, payments made upon a legal obligation are normally qualified as ‘taxes’ if they are made without any specific return (‘ohne spezielle Gegenleistung’). This seems to be the case with the special tax on the sum of wages (‘Lohnsummensteuer’), as exists in Austria and Germany. Without going into details it could be said that the payer of social security fees (or the person on whose account such payments are made directly or indirectly) receives specific rights against the social insurance in return for these contributions. Therefore the Working Party feels that contributions to social security funds can in principle *not* be considered to be ‘taxes’ in the meaning of paragraphs 1 and 2.

To avoid a misinterpretation of Article 2 it seems to be preferable to omit the specific reference to ‘taxes on the total amounts of wages or salaries paid by enterprises’. The omission would affect in no way the treatment of the ‘Lohnsummensteuer’ since it is considered to be a ‘tax’.<sup>448</sup> (emphasis in the original)

It becomes clear that social security payments involving a “specific return” cannot be seen to be “taxes on income and capital” in the meaning of the Model text. However, it appears that the Report of WP No. 30 as well as the current Commentary refer only to such social security schemes where the link between payments and benefits is straightforward; this is often not the case in domestic social

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<sup>443</sup> Some of the older treaties concluded by Denmark list old age pension contributions; see e.g. DTC Denmark–Kenya of 1972, Denmark–Luxembourg of 1979, Denmark–India of 1989 or Denmark–Italy of 1980 (terminated as of 1 January 2004; the new version does not include old age pension contributions). However, this has always been seen as an exception; the Danish Ministry of Taxation has specifically stated that the Danish social security contribution is not a tax covered by Danish tax treaties.

<sup>444</sup> See also van Raad, “The Concept of Tax in the OECD Model”, Paper for the 9th Annual EATLP Meeting on “The Concept of Tax” in Caserta, Italy (2005); 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”, *Bulletin for International Fiscal Documentation* October 2005, p. 432.

<sup>445</sup> Para. 3 of the 2005 Commentary on Art. 2(3) of the Income and Capital MC.

<sup>446</sup> Commentary on Art. 2(2) of the 2005 Income and Capital MC, m.no. 3.

<sup>447</sup> FC/WP 30(69)1, m.no. 26: “Austria has stated that it deletes the words ‘taxes on the total amounts of wages or salaries paid by enterprises’ in paragraph 2 of Article 2 of its Convention, to avoid a misinterpretation which might bring any fees or duties payable under the social security scheme within the scope of the Conventions.” (emphasis in the original)

<sup>448</sup> Id., m.nos. 27-28.

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security systems: social security schemes are commonly classified either as “funded schemes” or “unfunded schemes”.<sup>449</sup>

In funded schemes, contributions paid by the individual are saved to fund future benefits to this person. It has to be factored in, though, that no country has adopted an insurance system in its “pure” form, where only those who have contributed to the system are entitled to benefits, since this would leave out an array of people: unemployed persons, children, persons on parental leave, sick and disabled people. Lang has pointed out that “[i]f the entitlement of others is simply an exception, the existence of a direct connection between the levy and the individual benefit may be assumed.”<sup>450</sup> States that have adopted this type of system regularly regard social security charges, though compulsory, as quasi-social insurance premiums and not at all as taxes.<sup>451</sup>

In unfunded schemes, contributions are not retained to provide future benefits to those making the contributions; instead, current contributions are used to fund current benefits, which means that there is no economic link between an individual’s contributions and the benefit entitlement of that individual. This also necessitates financial participation of the state, which is why these systems are mainly financed through taxes. However, there will regularly be a formal link between benefit entitlement and contributions to ensure that only those who have contributed can benefit from the fund.

Both types of systems therefore entail a linkage between payments to a social security scheme and benefits paid from the scheme. To the extent that contributions do not match the amount of benefits, further forms of funding are often provided through general taxation. There are thus countries where a classification as either “funded” or “unfunded” is difficult.<sup>452</sup> Moreover, a state’s legislature may at any time change the formulas under which benefits are determined, which makes the entitlement to a benefit highly uncertain to the point that it is highly doubtful whether social security levies can be seen to be matched by a corresponding benefit they directly and identifiably give entitlement to.<sup>453</sup>

Vogel pointed out that social security charges do not qualify as taxes in the sense of Art. 2 since “[t]hey are directly connected with the benefit of enjoying the protection afforded by the social security system”, but also noted that “[t]here may be problems whenever a contracting State collects social insurance charges as taxes and when in such cases there is no direct connection between those charges and the benefits claimable under the social security system.”<sup>454</sup> No generally valid solutions can be presented in these cases; it may result from the context that even where a state uses the label of “social security taxes”, these charges are not meant to be included in tax treaties.<sup>455</sup>

An example of such a case can be found in Norway, where the “social insurance tax” is regulated as part of the income tax. Zimmer remarked: “Indeed, it is regarded as an income tax itself (except in an international context).”<sup>456</sup> Skaar stated: “It is common ground that the social insurance tax is not a tax in terms of the [Norwegian] tax treaties.”<sup>457</sup>

Another example is Denmark, where social security contributions are considered “taxes on income” that are levied by the state but earmarked for a special purpose. The Danish Ministry of Taxation has

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<sup>449</sup> See in more detail Williams, “Social Security Taxation”, in Thuronyi (ed.) *Tax Law Design and Drafting* (1996) pp. 4 et seq.

<sup>450</sup> M. Lang, *Bulletin for International Fiscal Documentation* 2005, p. 218.

<sup>451</sup> Messere, “20th Century Taxes and Their Future”, *Bulletin for International Fiscal Documentation* 2000, p. 7.

<sup>452</sup> Unclear cases are the social security systems of Greece, Italy, Portugal and Spain; for analytical and statistical purposes, they are mostly classified as unfunded. States like Austria, Belgium, France, Germany and Luxembourg are mostly seen to have funded schemes; the Nordic countries as well as the UK and Ireland are seen as epitomizing the unfunded scheme.

<sup>453</sup> See also Williams in Thuronyi (ed.) *Tax Law Design and Drafting* (1996) p. 7.

<sup>454</sup> K. Vogel, Commentary on Art. 2 para. 2, m.no. 29.

<sup>455</sup> Vogel argues that such result will “as a rule arise from the context of the treaty.” See m.no. 29, preceding note.

<sup>456</sup> Zimmer, “Norway”, *European Taxation* 2001, p. 55 (emphasis added).

<sup>457</sup> Skaar, “International Aspects of the Norwegian Imputed Personal Income Tax”, *Intertax* 1993/2, p. 77.

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consistently stated that the Danish social security contribution is not a tax covered by Danish tax treaties.<sup>458</sup>

From the fact that the Commentary refers only to “taxes on the total amount of wages paid by enterprises”, van Raad has concluded that the Commentary refers only to social security charges levied on employers and not to those collected from employees income earners in general, making the argument that the Commentary cannot be relied upon to claim that social security charges levied from (wage) income earners are excluded from the notion “tax” as employed in Art. 2.<sup>459</sup> Jiménez de la Rada deems van Raad’s reading of the sentence to be too literal, but stresses that “[V]an Raad simply was making the point that the reference to social security contributions in the Commentaries to Art. 2 OECD MC should not be interpreted with the meaning that social security contributions are always excluded from the scope of income tax treaties.”<sup>460</sup> Van Raad’s argument that the exemption concerns employer contributions only goes in line with the common observation that the connection between contribution and benefit is far greater for employee than for employer contributions, which leads to the approach in many states that employer contributions are not seen to be “proper” social security contributions, but general taxes.<sup>461</sup>

Nevertheless, the wording of the Commentary on Art. 2(2) does not warrant a distinction between employer and employee contributions, considering that the Report of WP No. 30 speaks of “the payer of social security fees (or the person on whose account such payments are made directly or indirectly).” Where such contributions qualify as taxes within the scope of a treaty, a credit may be due for taxes paid by the employee, or to the employer remitting payments on behalf of the employee.

The text of the Commentary, supplemented by the statements of WP No. 30, allows for the general conclusion that a contribution to a social security fund is a tax if there is a requirement to make payments to the fund of a government authority, but no conceptual element of benefit in the nature of a “social contract”. WP No. 30 speaks of “social security fees”, thereby implying the characteristic elements of fees and user charges, i.e. that they are directly linked to benefits and not pooled for general budgetary revenue. “Grey areas” due to increased funding of social security systems worldwide out of general taxation are not dealt with in either the Commentaries or the materials. The international context of the treaty is therefore examined more closely in the following section.

### **1.8.1. Influence of EC coordination law and social security conventions**

Where countries finance their social security system by way of general income taxes and do not separately levy social security charges – be it in the form of an earmarked tax or a premium identifiably linked to a benefit – the application of a tax treaty to that part of the general imposition that effectively finances social security will be undisputed. However, even these countries conclude social security agreements or, if they are EC Member States, implement the provisions of Reg. 1408/71.

The importance of clarification in this area becomes apparent when considering the example of a person liable to worldwide income taxation in one state, but performing work in another state, where separate social security charges are levied. If the social security scheme in the first state is financed by way of general taxation, the problem of double burdens upon the same income arises.

Where two EC/EEA Member States are concerned, Reg. 1408/71 provides that “a person employed in the territory of one Member State shall be subject to the legislation of that State even if he resides in the territory of another Member State or if the registered office or place of business of the undertaking

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<sup>458</sup> See Stockholm, “National Report Denmark”, in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006) p. 217 (226).

<sup>459</sup> Van Raad, “The Concept of Tax in the OECD Model”, Paper for the 2005 EATLP Meeting, p. 5.

<sup>460</sup> Jiménez, *Bulletin for International Fiscal Documentation* 2005, p. 433.

<sup>461</sup> See also Williams in Thuronyi (ed.) *Tax Law Design and Drafting* (1996) p. 11.

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or individual employing him is situated in the territory of another Member State.”<sup>462</sup> The Regulation “shall apply to all general and special social security schemes, whether contributory or non-contributory....”<sup>463</sup>

If the social security system of one of the states is financed fully or in part from general taxation, the distributive rules of a tax treaty might attribute jurisdiction to a person’s state of residence, as opposed to the state where the work is carried out. The tax treaty would thus be in violation of EC law.

The European Court of Justice has drawn a conceptual boundary between taxes from social security charges for purposes of Reg. 1408/71 in two joined cases concerning an infringement procedure of the Commission against France concerning levies on all categories of income of French residents working in another Member State.<sup>464</sup> The French levies concerned, called CRDS and CSG,<sup>465</sup> accrue to social security bodies under state authority and are categorized under French domestic law as “taxes on income”.<sup>466</sup> The CRDS and CSG are collected by the French social security authorities, in addition to France’s compulsory insurance scheme providing the right to social benefits; no corresponding benefits are granted with the payment of the CRDS and CSG. Their character as either taxes or social security charges is therefore not easily determinable and has been subject to debate among scholars in France.<sup>467</sup> The French tax authorities consider the CRDS and CSG to come within the scope of tax treaties concluded by France. The European Commission has opposed this view and argued that the CRDS and the CSG are not “taxes” but rather social security contributions to which the Regulation on the coordination of social security payments applies, with the consequence that such payments may only be levied in the state where the work is carried out.

The Advocate-General noted that “[t]hese cases concern the issue of moving gradually towards funding social security schemes from taxation” and proposed that in determining the nature of the levies involved, “the objective criterion to be adopted is ... the identification of a direct link between the measures in issue and the French social security scheme.”<sup>468</sup> The ECJ followed this view and took a broad approach in interpretation, upholding its previous case law according to which even “the fact that a rule is contained in a law which falls outside the scope of the Regulation does not necessarily imply that that rule itself falls outside the scope thereof”.<sup>469</sup> The Court stated that “the decisive factor for the purposes of applying Regulation No 1408/71 is that there must be a link between the provision in question and the legislation governing the branches of social security listed in Article 4 of Regulation No 1408/71, and that link must be direct and sufficiently relevant.”<sup>470</sup>

The decisive factor according to the Court is the fact that a certain levy effectively finances branches of the social security scheme. To quote the Court:

Neither the fact that the collection is effected by way of an assessment roll, together with the income tax, nor the fact that the payment does not give entitlement to any direct and identifiable benefit in return can undermine that conclusion. Otherwise, the provisions of Regulation No. 1408 of 71 against overlapping legislation would be deprived of all effectiveness.<sup>471</sup>

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<sup>462</sup> Art. 13(2)(a) of Reg. 1408/71.

<sup>463</sup> Art. 4(2) of Reg. 1408/71.

<sup>464</sup> ECJ, *Commission v. France*, Joined Cases C-34/98 and C-169/98, decision of 15 February 2000.

<sup>465</sup> The French social debt repayment contribution (*Contribution au remboursement de la dette sociale*, CRDS) and the general social contribution (*Contribution sociale généralisée*, CSG).

<sup>466</sup> For further references, see Suchy, “National Report France”, in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006) p. 259 (275).

<sup>467</sup> Id.

<sup>468</sup> Opinion of A-G La Pergola, delivered on 7 September 1999, m.nos. 2 and 24, resp.

<sup>469</sup> See *Rheinhold & Mahla NV v. Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid*, C-327/92, decision of 18 May 1995, m.no. 22.

<sup>470</sup> ECJ, *Commission v. France*, C-34/98, m.no. 35; C-169/98, m.no. 33.

<sup>471</sup> Decision C-34/98, m.no. 38.



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The Court also rejected the argument made by the French authorities that in order to be considered a social security contribution in the sense of Reg. 1408/71, a levy has to give entitlement to a direct and identifiable benefit in return:

[F]or the purposes of the application of Article 13 of Regulation No 1408/71, the decisive criterion is that of the specific allocation of a contribution to the funding of the social security scheme of a Member State. Whether benefits are obtained or not in return is therefore irrelevant in this connection.<sup>472</sup>

With regards to the coverage of the CRDS and the CSG under tax treaties concluded after the introduction of these levies,<sup>473</sup> the French *Conseil d'État* has held that in the case of an exhaustive listing that does not mention the CRDS or the CSG, they will not be covered, as they cannot be seen to be taxes accessory to the income tax.<sup>474</sup> However, they will be covered under tax treaties that contain a general description like Art. 2(1) and (2). In these cases, the coordination provisions contained in Reg. 1408/71 may be in conflict with the distributive rules of tax treaties.

This issue was at the heart of a case decided by the ECJ on 3 April 2008. In *Philippe Derouin v. Union pour le recouvrement des cotisations de sécurité sociale et d'allocations familiales de Paris*,<sup>475</sup> the ECJ dealt again with the application of the coordination provisions of Reg. 1408/71 to the CSG and CRDS. The French levies were imposed on UK-sourced income of a French resident taxpayer, Mr Derouin (“the taxpayer”), a member of a UK partnership. While the taxpayer performed all work in France, the profits were received through the UK partnership treated as a flow-through entity for tax purposes. The taxpayer was taxed as a French resident for individual income tax purposes and paid social security contributions in France on his French and foreign-source income. He challenged the payment of these contributions to the extent they were based on UK-sourced income, arguing that the contributions paid in the form of the CSG and CRDS are taxes giving rise to protection under the income tax treaty between France and the United Kingdom. The French social security authorities rejected this proposition and argued that the CSG and the CRDS are social security contributions rather than taxes and should come within the scope of EC Regulation 1408/71, under which all occupational income is should be subject to social security levies exclusively in France.

The case was thus presented to the ECJ to determine whether Reg. 1408/71 could prevent a tax treaty from carving out a French resident’s foreign-source income from application of the French social security regime. The Court, albeit not commenting conclusively on whether the CSG and CRDS should be classified as taxes or social security contributions, confirmed that these levies generally come within the scope of EC Regulation 1408/71. It stressed that the Regulation is a means of coordination rather than of harmonization, its primary purpose being to ensure the freedom of movement of workers throughout the European Union. The Court confirmed its prior rulings in *Commission v. France* in stressing that the fact that a levy is categorized as a tax under domestic law does not mean that the same levy cannot come within the scope of the Regulation.<sup>476</sup>

Following the conclusion of a new income tax treaty between France and the United Kingdom on 28 January 2004 (which expressly lists the CSG and CRDS among the French taxes covered under the Convention) treaties concluded by France have been made reference to these levies as taxes covered.<sup>477</sup>

Moreover, France has passed legislation to the effect that CRDS and CSG apply only to income subject to the French income tax and social security legislation.<sup>478</sup> Similar actions were taken in other countries in the aftermath of the ECJ decisions; for instance, the Austrian Federal Ministry for social

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<sup>472</sup> Decision C-34/98, m.no. 40; see also the decision C-169/98, m.no. 37.

<sup>473</sup> The CSG was introduced in 1990, the CRDS was introduced in 1996.

<sup>474</sup> See for more details Suchy in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006) p. 259 (276).

<sup>475</sup> Case C-103/06, OJ C 128 (2008).

<sup>476</sup> C-103/06 (*Philippe Derouin*) m.no. 22.

<sup>477</sup> An example is the non-exhaustive list in Art. 2(3)(a)(ii) and (iii) of the France–Georgia Income and Capital Tax Treaty of 7 March 2007 (not yet in force), which makes reference to the CSG and CRDS.

<sup>478</sup> See Suchy in M. Lang (ed.) *Double Taxation Conventions and Social Security Conventions* (2006) p. 259 (276).

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affairs has amended the obligation of employers to make payments based on payroll into the family burdens equalization fund on behalf of employees working within the country or sent abroad to work for the employer.<sup>479</sup> The contributions are therefore not payable if expatriates are not covered by the Austrian social security system according to Reg. 1408/71, as in such circumstances they are not entitled to family allowance payments. However, these contributions are sometimes explicitly listed in Austrian treaties.<sup>480</sup> Moreover, they may come within treaty scope if the treaty contains a general description that mentions “taxes on the total amounts of wages and salaries paid by enterprises.”<sup>481</sup>

In effect, only such charges that are not effectively used to finance social security can be seen to be outside the scope of Reg. 1408/71. According to consistent jurisprudence of the ECJ, the concept of “tax” is to be interpreted autonomously for purposes of the EC legal order, without regard to national definitions.<sup>482</sup>

In a decision of 2001, the ECJ again confirmed that a levy may come under Reg. 1408/71 despite the fact that it is classified as a regular tax under a Member State’s domestic law. In an obiter dictum to this decision, the Court made it clear that in order to qualify as a social security contribution under the Regulation, the levy does not need to be imposed directly; rather, levies paid by employers, undertakings or industries are regularly seen to come within the scope of Reg. 1408/71.<sup>483</sup> The Court thus makes no distinction whether the levies are imposed directly on the employee or to be paid by the employer. However, liability of third parties has been held not to bring social security payments within the scope of the coordination provisions of Reg. No. 1408/71.<sup>484</sup>

Existing ECJ decisions imply that levies that effectively accrue to the government’s *general* budget are considered as “taxes”.<sup>485</sup> Compulsory payments that effectively finance social security, however, have been ruled to fall under the EC coordination provisions. This functional approach of the ECJ prevents the provisions of the Regulation from being rendered obsolete at random by virtue of labelling charges in a certain way or attributing them to certain funds under domestic law. Moreover, the approach taken by the Court not to consider the receipt of benefits in return for the payment seems feasible, as the notion of “benefit” is fungible and lies within the realm of government control.

Interestingly, the argumentation of the ECJ is consistently rather broad and does not seem to be confined to levies on employment and self-employment income, but appears to be applicable to income in general.<sup>486</sup>

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<sup>479</sup> Statutory notice (“*Erlass*”) of the Austrian Ministry for social affairs of 27 January 2003, GZ 51 0802/8-V/1/03, AÖFV Nr. 56/2003 on employer contributions to the Austrian family burdens equalization fund (“*Arbeitgeberbeitrag zum Familienlastenausgleichsfonds*”).

<sup>480</sup> See, e.g., the 1959 Austria–Sweden tax treaty, Art. 1(4)(2)(d).

<sup>481</sup> Cf. the Austrian Ministry of Finance in EAS.1914 of 17 August 2001, stating that the Austria–Liechtenstein tax treaty does not apply to employer contributions to the Austrian family burdens equalization fund; the treaty did not contain a reference to “taxes on the total amounts of wages and salaries paid by enterprises.” For more on this issue, see Züger, “Kommunalsteuer, sonstige Lohnabgaben und Doppelbesteuerungsabkommen”, SWI 2000, pp. 164 et seq.

<sup>482</sup> See ECJ C-295/84, ECR 1985 at I 03759; C-200/90, ECR 1992 at I-02217; C-197/94 and C-252/94, ECR 1996 at I-00505; C-4/97, ECR 1998 at I-06469; C-375/98, ECR 2000 at I-04243; C-113/99, ECR 2001 at I-00471; and C-294/99, ECR 2001 at I-06797. For a detailed analysis of the different concepts of tax in various contexts of EC law see Kreibohm, *Der Begriff der Steuer im Europäischen Gemeinschaftsrecht* (2004).

<sup>483</sup> ECJ, C-68/99, decision of 8 March 2001, m.no. 11; the case concerned the German “*Künstlersozialabgabe*”, a levy imposed on the total amount of wages paid by editors or agencies to artists and journalists.

<sup>484</sup> See the statements of the Court in *Rheinhold & Mahla NV v. Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid*, C-327/92, decision of 18 May 1995, m.nos. 27-30, regarding payments made by a Netherlands main contractor: “Although a certain link undeniably exists between the social security obligations of an employer and the liability of a main contractor ... it has to be said that the link is indirect only. The principle established by the Netherlands legislation that the main contractor is to be liable is not based upon the existence of an employer-employee relationship between the main contractor and the workers in respect of whom the contributions are payable ... Thus, ... that contractor is not, strictly speaking, liable to pay social contributions.”

<sup>485</sup> See also Waldhoff, “Die Abgrenzung von Steuern und Sozialabgaben im europäischen Recht”, in Becker/Schön (eds.) *Steuer- und Sozialstaat im europäischen Systemwettbewerb* (2005) p. 193 (198). For more on the different concepts of tax in the various areas of EC law, see Kreibohm, *Der Begriff der Steuer im Europäischen Gemeinschaftsrecht* (2004).

<sup>486</sup> Pieters, “What is a social security contribution and what is a tax?”, in Pieters (ed.) *Sozialrecht und Sozialpolitik in Deutschland und Europa, liber amicorum Bernd Baron von Maydell* (2002) p. 528.

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As between EC/EEA Member States, the distributive rules of tax treaties are superseded by the coordination provisions of the Regulation. If, for example, the residence state of a worker is a credit state, both the source state and the residence state may have jurisdiction to tax his/her income under Art. 15 of the OECD Model, whereas under Reg. 1408/71 only the state where the work is carried out is entitled to levy social security charges. The Regulation applies irrespective of whether there is a link between the payment and subsequent benefits granted. To avoid violations of EC law, Art. 2 in tax treaties concluded between EC/EEA Members States should therefore be interpreted in a way that excludes charges covered by Reg. 1408/71.<sup>487</sup>

Such delineation may yield viable results also in the case of two states that have concluded a tax treaty as well as an international agreement in the area of social security. Since social security agreements refer to “social security legislation” and separately name specific contributions and/or benefits, their scope may in principle encompass charges directly linked to individual benefits as well as charges where the link can be seen to be indirect.<sup>488</sup> Moreover, the fact that the ECJ did not attribute any relevance to the connection between the charge and subsequent benefits, one could argue with merit that there are no grounds for a “benefit test” with respect to the application of social security agreements.

Thus, to the extent that the coordination rules of a social security agreement come into conflict with the distributive rules of a tax treaty, the levy concerned may be seen to be outside treaty scope. As social security agreements list in detail the branches of a country’s social security legislation that shall be covered, arguably these agreements are *leges speciales* to the provisions of tax treaties. The approach taken for purposes of treaties following the US Model confirms this: the Technical Explanation gives the following reason for the express exclusion of US social security taxes from the scope of tax treaties:

It is expected that the issue of two countries requiring social security payments from a person resident in one state but working in another is dealt with in the more special provisions of bilateral social security conventions.<sup>489</sup>

This line of reasoning is also used in the academic literature of countries other than the United States<sup>490</sup> and appears to be feasible with respect to any country that has concluded social security agreements.

The issue is complicated by the fact that most social security agreements as well as Reg. 1408/71 apply to “present or future” legislation,<sup>491</sup> a provision that is comparable in its effect to Art. 2(4) of the OECD Model. Unclear cases may thus arise where a state replaces its contributory social security system by a system that is financed out of general taxation. In the case of such substantial changes, it is certainly arguable that the social security agreement or the Regulation should no longer apply, and an examination is warranted as to whether the tax treaty may be applicable.

Another aspect to be taken into account is that in most governments, the authorities negotiating social security agreements will not be the same authorities as those that negotiate and administer tax treaties. As Jiménez pointed out (see note 487), it would seem unusual to include within the scope of a tax treaty such levies that are outside the powers of the tax authorities. Where domestic law attributes competences regarding certain levies to government bodies other than the bodies associated with taxation, there is a strong argument that these levies should not come within the scope of tax treaties.<sup>492</sup>

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<sup>487</sup> See also the argument made in this vein by Jiménez, *Bulletin for International Fiscal Documentation* 2005, p. 435.

<sup>488</sup> At one point, the Regulation speaks of “contributions or similar payments”: see Art. 33(2) of Reg. 1408/71.

<sup>489</sup> Technical Explanation to Art. 2 of the US Model Income Tax Convention of 20 September 1996.

<sup>490</sup> See, e.g., Oberson/Hull, *Switzerland in International Tax Law* (2006) p. 81.

<sup>491</sup> Art. 1(j) of Reg. 1408/71.

<sup>492</sup> Cf. the argument made in Jiménez, *Bulletin for International Fiscal Documentation* 2005, p. 436.

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As has been shown, the interpretation of Art. 2 should take into account the existence of bilateral agreements as well as EC legislation with respect to social security charges. Some solutions have been proposed that may be of use in the individual case, but it should be reiterated that there are no ultimate solutions at this intersection of international tax law and international social security law.

### **1.8.2. A note on taxes withheld under Directive 2003/48/EC**

In the following, the question of how cross-border investment payments that suffer withholding tax under the provisions of the EC Savings Directive should be treated under tax treaties is broached, since cases of conflict may currently arise, albeit for a transitional period and with respect to certain EC Member States only.<sup>493</sup>

The EC Savings Directive<sup>494</sup> was adopted to tackle the problem of tax evasion especially incumbent with respect to savings income in the form of interest payments. The term “interest payment” is defined in Art. 6 of the Directive as comprising, “in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payments are not regarded as interest payments.” The provisions of the Savings Directive are to ensure that said payments made in one Member State to individuals resident for tax purposes in another Member State are subject to taxation in that other state.<sup>495</sup> The Directive enables effective taxation through an exchange of information in that the paying institution must report to the competent tax authorities any payments of interest to the Member State of which the recipient is a resident.<sup>496</sup>

Due to bank secrecy laws in Austria, Belgium and Luxembourg, these countries have been granted adoption of a special withholding tax system for a transitional period, in lieu of automatic exchange of information as described above. These countries have agreed to withhold tax at a rate of 15% of the gross interest received for the first 3 years, rising to 20% until 1 January 2008 and 35% thereafter, until 1 January 2011. Revenue is shared as between the source state and the recipient’s residence state.<sup>497</sup>

The portion retained by the collecting Member State could be seen as a fee for the service of collecting the tax that is outside tax treaty protection.

The EC Savings Directive provides for a full tax credit to be granted by the residence state for the special withholding tax.<sup>498</sup> The rationale is to adequately meet the goal of the Directive to prevent tax evasion, yet without imposing additional burdens on taxpayers.<sup>499</sup>

Since the EC Savings Directive has been transposed into domestic law in the respective countries, the withholding by an agent permanently resident in Austria, Belgium or Luxembourg may qualify as a domestic tax burden that is subject to tax treaty provisions.

On its face, the amount withheld could be considered a *tax on income and capital levied on behalf of a contracting state* as per Art. 2(1) and (2). Two complications arise in this context, however. The fact

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<sup>493</sup> The area is under development; see further European Commission, Expert Group on Taxation of Savings, Review of the operation of the Council Directive 2003/48/EC on taxation of income from savings, Working Paper from a Meeting on 22 March 2007, 000701\workingdoc/en-05-08.

<sup>494</sup> Council Directive No. 2003/48/EC of 3 June 2003 on Taxation of Savings Income in the form of Interest Payments, OJ L 157/38, effective 1 July 2005.

<sup>495</sup> See Art. 1 (Aim of the Directive).

<sup>496</sup> Art. 8 (Exchange of Information).

<sup>497</sup> Art. 10 (Transitional Period); Art. 11 (Withholding Tax).

<sup>498</sup> Art. 14 (Elimination of Double Taxation).

<sup>499</sup> A different issue presents itself where the tax credit to be granted by the residence state under the Savings Directive may lead to a net loss where that country exempts its residents from tax on interest received from domestic paying agents. As the credit under the Directive is irrespective of domestic credits, resulting net losses are obviously not within the purview of the Directive which focuses mainly on preventing tax avoidance.

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that the source state retains a fixed percentage of the revenue while passing on the remaining fraction to the recipient's state of residence might suggest that the amount retained is a *fee* for providing the service of collecting a tax on behalf of the residence state.

The second complication is closely interwoven with the first in that it is unclear whether the payment is levied *on behalf of* the source state or rather on behalf of the residence state. Lozev has compared the revenue apportionment under the EC Savings Directive to precedents in the area of the European Community's own resources and its system of recovery of claims. He concludes that in view of the fact that there is no link between the percentage withheld and the cost of collection, it appears that this percentage amount is a tax levied for the benefit of the collecting agent.

However, it is unclear whether the entire amount withheld in accordance with the Savings Directive could be classified as a tax levied on behalf of either the source or the residence state under a tax treaty. In the tax treaty context, it can arguably be concluded that the state that has jurisdiction over the paying agent is the one on behalf of which the tax is levied.<sup>500</sup> Tax treaties tie in with existing taxing powers and there is no indication that the way that revenue is used is relevant in determining "on behalf of" which state a tax is levied in the sense of Art. 2.

The state where the paying agent is located should therefore be classified as the source state and would thus be granted primary taxing rights under Art. 11 of the MC. This result is in line with the EC Interest and Savings Directive, as the Directive obliges the recipient's country of residence to avoid double burdens. However, where a tax treaty does not follow the Model Art. 11 allocation rules, the result may be incoherent with the Directive's provisions. A practical example is Art. 11 in the tax treaty concluded between Austria and Germany, giving exclusive taxing rights to the residence state of the recipient. As to payments made by an Austrian paying agent (as defined in the EC Interest and Savings Directive) to a recipient resident in Germany, this would mean a result under the treaty that is counter to EC law. As between EC Member States, EC law supersedes the tax treaty in cases of conflict.

Nevertheless, impositions under the EC Interest and Savings Directive may generally come within the general description of Art.2(1) and (2) in tax treaties. In the alternative, they qualify as "substantially similar" to the taxes listed in Art. 2(3), as per Art. 2(4). The result is a correlation of tax treaty protection and the goals of the EC Interest and Savings Directive.

## **2. Art. 2 in the system of the treaty**

The concepts underlying the formulations in Art. 2 determine the scope of the treaty for purposes of allocating existing jurisdictions to tax as between the states involved regarding certain taxable events and of eliminating double taxation with respect to these events.

To enable its effective application, the tax treaty must be seen as a closed system. The following provides an overview from the perspective of the place Art. 2 takes within the overall system of the treaty.

### **2.1. Relation to the distributive rules**

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<sup>500</sup> For an in-depth analysis see S. Heidenbauer, "Internationale Aspekte der EU-Quellensteuer", SWI 10/2006, pp. 459 et seq.

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Arts. 6 through 22<sup>501</sup> are referred to as “distributive rules”,<sup>502</sup> “allocation rules” or “limitation rules”,<sup>503</sup> to describe their function of allocating among the contracting states their respective inherent right to tax under domestic law. This is achieved by restricting taxation in the state of source.

The relation between these rules and the provisions in Art. 2 is one of essential interdependence: Any tax that is covered under Art. 2 is to be dealt with as a taxable item under one of the distributive rules. This is effected by the “catch-all clause” in Art. 21, which enables treaty application to residual taxable items.<sup>504</sup> Moreover, the provision on the substantive scope of the treaty is determinative in the process of applying the distributive rules; conversely, inferences may be drawn from the distributive rules as to the substantive scope of the treaty. An approach neglecting the nature of the treaty as a closed system would gravely endanger its effective functioning.

The interaction between Art. 2 and the distributive rules can play a role for purposes of determining the substantive scope of the treaty, as is evidenced by a case of the Austrian Supreme Administrative Court of 2001<sup>505</sup> regarding the Austria–Japan tax treaty: the treaty did not provide a general description of taxes covered and contained an exhaustive list of taxes covered that did not enumerate the Austrian trade tax. However, the distributive provision equivalent to Art. 8 on shipping, inland waterways transport and air transport contained an explicit exemption from the Austrian trade tax for Japanese transport enterprises. The argument was whether this exemption extended also to the newly created municipal tax.<sup>506</sup>

The ruling of the Court was based on the premise that the mere fact that the distributive rule dealt with the issue but did not provide for an automatic extension as contained in the provision equivalent to Art. 2(4) could in no way justify denying its application in the spirit of such latter provision. The Court thus analysed the treaty as a system wherein the personal and substantive scope and the distribution and elimination rules tie into each other to create a reliable framework for the avoidance of double taxation.

As the taxes covered under Art. 2 necessarily correlate to their treatment under the distributive rules, only such taxes as come within the scope laid out in Art. 2 can be dealt with as per Arts. 6 to 22; what is more, any tax that can be seen to be covered under Art. 2 will in any case come within one of the distributive rules of the treaty, as is evinced by the “catch-all clause” in Art. 21.

Therefore, in determining the substantive scope of tax treaties the fact must not be overlooked that it is in the nature of Art. 2 to tie into the distributive rules of the treaty; if the parties expressed their objective intent with regard to a tax in the distributive rules, it would go against object and purpose of the treaty not to align this agreement with the other provisions that are part of the functional build-up of the treaty.

## **2.2. Relation to the elimination rules**

The “elimination rules” in Art. 23<sup>507</sup> set forth the methods for effective elimination of double taxation in the state of residence, explicitly stating that they apply to those objects and events that “may be

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<sup>501</sup> Arts. 5 to 7 in the Estates, Inheritances and Gifts MC. The provision on associated enterprises in Art. 9 of the Income and Capital MC is difficult to categorize as it may function in some cases to achieve an appropriate allocation of taxing jurisdictions, and in others to counter deliberate tax avoidance. See also Baker, Commentary, Introductory Topics, m.no. D.01 of June 2001.

<sup>502</sup> K. Vogel uses this term throughout his Commentary to the OECD MC.

<sup>503</sup> This term is suggested in Shelton, *Interpretation and Application of Tax Treaties* (2004) p. 126.

<sup>504</sup> See also M. Lang, *Einführung in das Recht der Doppelbesteuerungsabkommen* (2002) m.nos. 200 et seq.

<sup>505</sup> Austrian Supreme Administrative Court, case No. 2000/13/0134 regarding the Austria–Japan Income Tax Treaty of 1961, decision of 28 March 2001; merits of the case discussed by Urtz, “Anwendbarkeit des Art. VIII DBA Österreich–Japan auf die Kommunalsteuer”, SWI 2001, p. 288.

<sup>506</sup> Cf. the considerations in Part II, Chap. 5. of this thesis.

<sup>507</sup> Art. 9 in the Estates, Inheritances and Gifts MC. The term “elimination rules” is referred to in K. Vogel, Commentary on Art. 23, m.no. 36a.

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taxed in the other Contracting State”, which indicates the direct connection to the outcome of allocation under the applicable distributive rule. The respective first paras. of Art. 23A and Art. 23B are identical in providing that “[w]here a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall...”

According to Art. 23, relief from double taxation is attained by two alternative methods: in essence, under the exemption method as provided in Art. 23A the state of residence exempts the taxable item described in one of the distributive rules from taxation under its domestic laws; under the credit method in Art. 23B, the residence state credits the tax levied in the source state against the tax levied under its domestic laws. As is the case with the distributive rules, there is an implicit functional link between the substantive scope and the elimination rules in that the latter only apply in respect of taxes covered under the treaty. The elimination of double taxation firmly rests upon the prerequisites expressed in Art. 2.

In a decision of the Swedish Supreme Administrative Court regarding the question whether Swedish income and capital tax treaties applied to a newly imposed temporary tax on profit distributions, the Court held that all treaties applied to the new tax – with the exception of the treaty with Belgium, as the exemption provision of this treaty restricted its application to the national and municipal income tax only.<sup>508</sup> In conformity with what has been stated in the foregoing section regarding the distributive rules, an agreement expressed in the elimination rules will have similar repercussions on the substantive scope of the treaty; in the majority of cases, the parties will be careful to align the provision on personal and substantive scope with the rules regarding distribution of tax jurisdictions and elimination of double taxation, so as to ensure the effective functioning of the treaty.

It is worth noting another aspect in which Art. 2 and Art. 23 are intertwined. Art. 23 is directed at the “resident of a Contracting State”, the term being defined in Art. 4 as “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State *and any political subdivision or local authority thereof*” (emphasis added).<sup>509</sup> Thus, not any taxpayer, wherever located, qualifies for treaty benefits. Until the 1963 OECD Model, the term “resident” was not commonly used. The 1928 League of Nations Model Convention referred to “fiscal domicile” in the sense of a source rule; this meaning was abandoned in the Mexico and London Models, where the term “fiscal domicile” was used instead to denote worldwide tax liability.<sup>510</sup> Art. 2 determines the taxation authority to which the treaty applies in referring to the “Contracting State or its political subdivision or local authority.”

In a case concerning the Luxembourg–Spain Income and Capital Tax Treaty of 1986,<sup>511</sup> the relationship between the treaty’s substantive scope and the rules on elimination of double taxation was at issue. The Luxembourg tax authorities denied the right to credit Spanish tax against the Luxembourg municipal business tax (MBT) even though this tax was explicitly listed in Art. 2(3) of the treaty. The argument made was that the elimination provision in Art. 24(1)(b) of the treaty made no reference to *any political subdivision or local authority*; albeit a tax levied on “elements of income or of capital” in the sense of Art. 2, the authorities argued that no credit was possible under the treaty against the MBT since it is levied on behalf of the Luxembourg municipalities. The government noted that the inclusion of MBT in the list of taxes in the treaty was made merely to prevent conflicts regarding the existence of a PE and the taxation rights relating to PEs.

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<sup>508</sup> Swedish Supreme Administrative Court (*Regeringsrätten*) Case No. 5823-1985, decision of 6 March 1986, as discussed by Kesti, “Temporary Tax on Profit Distributions”, *European Taxation* 1987, pp. 30 et seq.

<sup>509</sup> Art. 4(1) of the Income and Capital MC (emphasis added). Similarly, Art. 4 in the Estates, Inheritances and Gifts Tax MC states that “‘person domiciled in a Contracting State’ means any person whose estate or whose gift, under the law of that State, is liable to tax therein by reason of the domicile, residence or place of management of that person or any other criterion of a similar nature.”

<sup>510</sup> See the in-depth analysis of Hattingh, “Article 1 of the OECD Model: Historical Background and the Issues Surrounding It”, *Bulletin for International Fiscal Documentation* 2003, pp. 215 et seq.

<sup>511</sup> *Cour Administrative du Grand-Duché du Luxembourg*, decision of 17 January 2006, No. 20.316 C. See further Chambers, “Luxembourg: Why foreign tax credits cannot reduce municipal business tax”, ITR April 2006.

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The Luxemburg Administrative Tribunal held against the government on the grounds that Art. 2(1) of the treaty clearly stated that it “shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied”. The scope laid out in Art. 2 was seen to carry over to the methods of avoiding double burdens. The Tribunal further noted that municipalities are covered by the wording “local authorities or political subdivisions” in Art. 2 since a municipality is not an independent body but a subdivision of the state of Luxemburg.<sup>512</sup> The court of first instance in Luxemburg thus applied the treaty autonomously as a “closed system”. The Luxemburg Administrative Court, however, reversed this decision and decided that the Spanish income tax may be credited only against the Luxembourg individual and corporate income tax but not against the MBT. The Court reasoned that the wording of Arts. 23A and 23B of the OECD Model does not provide for detailed rules on how to apply the tax credit provided by the treaty. The Court drew on Art. 3(2) and concluded that anything not covered by the treaty will be treated in accordance with internal law which does not grant a foreign tax credit against the MBT.

This decision was heavily criticized as being contrary to the object and purpose of the treaty.<sup>513</sup> Luxemburg made no reservations to the treaty nor did parliamentary documents issued in the context of negotiating the treaty speak to the mechanics of the tax credit. The Court should thus have analysed the treaty independently of domestic concepts. Where the provision on substantive scope provides for the treaty to apply to taxes levied on behalf of political subdivisions and local authorities, this carries over to all functional aspects of eliminating double taxation under that treaty.

An analysis of the treaty from its context and systematic build-up and with a view to its object and purpose clearly points to the fact that the article laying out the elimination of double taxation ties in with the provision on substantive scope. The analysis of Art. 2 of a treaty therefore has direct bearing on its effective functioning.

### **2.3. Different concepts of tax within the treaty**

As was shown above, the provision on substantive scope ties into the other “functional provisions” of the treaty distributing tax jurisdictions and eliminating double taxation as between the contracting states. Within this “closed system”, the concept of tax is necessarily a homogeneous one that enables effective treaty application.

Entirely different concepts of tax may be called for in the context of treaty articles that apply unattachedly to the described system, as they are meant to fulfil separate, stand-alone goals.

The provisions in the treaty providing for non-discrimination, exchange of information and assistance in the collection of taxes (Arts. 24, 26 and 27, resp.) have a different reach as compared to the “functional provisions” and have different conceptual underpinnings of “tax”.<sup>514</sup> Their relationship with Art. 2 will therefore be examined more closely in the following.

#### **2.3.1. The non-discrimination provision**

The non-discrimination provision in Art. 24 of the Income and Capital MC<sup>515</sup> is a special rule of international law that supplements anti-discrimination rules in domestic law and in EC tax law;<sup>516</sup> it is designed to implement equity principles in matters of tax treaty law.<sup>517</sup>

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<sup>512</sup> *Tribunal administratif de Grand-Duché de Luxembourg*, No. 18.793 and No. 19.298.

<sup>513</sup> See the in-depth discussion and criticism offered in Joosen/Taferner, “Luxembourg – Getting the (Foreign Tax) Credit One Deserves?”, *European Taxation* April 2006, p. 178 et seq.

<sup>514</sup> Cf. van Raad, Paper for the 9th Annual EATLP Meeting on “The Concept of Tax” in Caserta, Italy (2005).

<sup>515</sup> An analogous provision is contained in Art. 10 of the 1982 Estates, Inheritances and Gifts MC.



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The 2008 IFA Congress in Brussels dealt with the current status of Art. 24 of the OECD Model and recommended changes needed to improve its legal certainty and effectiveness.<sup>518</sup> Anything said within the confines of the thesis at hand would not do this topic justice. The present analysis of Art. 24 therefore focuses on its relation to the substantive scope of tax treaties.

Non-discrimination provisions can be found since the earliest tax treaties.<sup>519</sup> Initially, such provisions were included in general commercial treaties such as treaties of friendship, commerce and navigation. The content of the non-discrimination principle is in essence the same throughout the nations: equal cases should be treated equally and unequal cases should be treated unequally.<sup>520</sup> There is, however, no internationally recognized general rule prohibiting fiscal discrimination that could be derived from customary international law.<sup>521</sup> Some countries have not included a non-discrimination article in their treaties due to the far-reaching scope implied by the broad formulations of Art. 24 of the OECD Model.<sup>522</sup>

Art. 24 consists of six paragraphs, the first five of which specify the “personal scope” of the clause by way of naming criteria with respect to which discrimination is not permitted to the contracting states under their respective domestic laws. Art. 24(1) provides that the application of this paragraph to nationals of a contracting state shall not be restricted by Art. 1 of the MC, which refers to residents.<sup>523</sup> This express clarification in the treaty text was first suggested in a 1968 Report of WP No. 28 dealing with Art. 1. The WP suggested two possible texts for clarification either in Art. 1 (“Without prejudice to the provisions of Article 24, this Convention shall apply to persons who are residents of one or both of the Contracting States.”) or in Art. 24 (“The provisions of this Article shall not be limited by the provisions of Article 1.”).<sup>524</sup>

Similarly, para. 6, describing the “substantive scope” of Art. 24, reads: “The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.” The express statement that the scope of Art. 24 is in no way linked to the substantive scope of the treaty can be explained by the broad purpose of avoiding differential treatment that might be sabotaged if it depended on the scope of taxes covered under the treaty; therefore, the non-discrimination provision goes beyond the treaty rules allocating jurisdiction to tax.<sup>525</sup> The US Model and the UN Model, as well as the Nordic Convention, each contain a largely analogous provision.<sup>526</sup> Greece, Ireland,

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<sup>516</sup> K. Vogel, Commentary on Art. 24, m.no. 5. For an extensive coverage of the provision, see Avery Jones, “The Non-Discrimination Article in Tax Treaties”, *European Taxation* 1991, pp. 309 et seq.; van Raad, *Non-Discrimination in International Tax Law* (1986). The drafting history of Art. 24 is laid out by M. Lang, “Die Arbeiten der OEEC und der OECD zur Schaffung der Diskriminierungsverbote”, in Lang/Schuch/Staringer (eds.) *Die Diskriminierungsverbote im Recht der Doppelbesteuerungsabkommen* (2006) pp. 31 et seq.

<sup>517</sup> For a recent study of cases involving the non-discrimination provision, see Avery Jones/Bobbett, “OECD: Interpretation of the non-discrimination article of the OECD Model”, 62 *Bulletin for International Taxation* 2 (2008) 50 et seq.

<sup>518</sup> Luc Hinnekens/Philippe Hinnekens, “General Report, Non-discrimination at the crossroads of international taxation”, *Cahiers de droit fiscal international* Vol. 93b (2008) 15.

<sup>519</sup> See, e.g., Art. 17 of the 1924 Austria–Hungary income tax treaty, relating to the same treatment in fiscal matters and the same judicial protection.

<sup>520</sup> Kuleshova, “Trends in Interpretation of Non Discrimination Clauses”, in Stefaner/Züger (eds.) *Tax Treaty Policy and Development* (2005) p. 451 (453) discussing also the relativity of the concepts of equality and inequality necessitating comparison on a singular case-to-case basis.

<sup>521</sup> Adonnino, “General Report on Non-discrimination rules in international taxation”, IFA *Cahiers de droit fiscal international* Vol. 78b, p. 25.

<sup>522</sup> An example is Australia, whose authorities have made it clear that disadvantages may arise from the inclusion of a broad non-discrimination article, as the language therein is too imprecise. With respect to the US–Australia Income Tax Treaty, see the elaborations of Goldberg/Glicklich, “Treaty-Based Non-discrimination: Now You See It Now You Don’t”, 1 *Fla. Tax Rev.*, pp. 51 et seq.

<sup>523</sup> See the text of Art. 24(1) (“notwithstanding the provisions of Article 1”), as well as the 2005 Model Commentary to Art. 24 para. 1, m.no. 2.

<sup>524</sup> OECD, WP. No. 28 of the FC, 2nd Report on Articles 1,4,14 to 20 and 21, FC/WP 28(68)2, Paris, 19 December 1968, m.no. 23. The Mexico and London Drafts had contained discrimination articles based on residence.

<sup>525</sup> See also K. Vogel, Commentary on Art. 24 para. 6, m.no. 175.

<sup>526</sup> The US Model makes clear that the provision extends beyond the substantive scope to apply to taxes of every kind and description “imposed by a Contracting State or a political subdivision or local authority thereof.” For more on the non-

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Luxembourg and the United Kingdom have made a reservation to the Commentary to maintain the right to restrict the application of the article to taxes covered by the Convention.<sup>527</sup> Where no such reservation exists, treaties that do not contain a provision corresponding to Art. 24(6) raise questions as to the taxes to which the non-discrimination provisions apply.

Raupach has argued that the non-discrimination provisions are by their very nature designed to apply to any taxes, irrespective of whether they are within the substantive treaty scope, as the purpose of avoiding discriminatory tax treatment goes beyond the allocation of jurisdiction to tax and the elimination of double taxation.<sup>528</sup> Debatin has countered that such an expansion cannot be presumed where the treaty lacks a provision corresponding to Art. 24(6).<sup>529</sup> It is the prevailing view in academic literature that whenever Art. 24(6) is not included, it is to be understood that the non-discrimination provision applies only to the taxes covered by Art. 2 of the Convention.<sup>530</sup>

An interesting case in this context arose with respect to the Canada–Netherlands treaty:<sup>531</sup> In a case before the Netherlands Supreme Court the question arose whether the treaty, under which the substantive scope in Art. 2 was limited to “taxes on income”, applied to the Dutch capital tax on enterprises for purposes of the non-discrimination provision.<sup>532</sup> While the treaty did not contain a provision like Art. 24(6) of the OECD Model stressing that the non-discrimination clause applies to “taxes of every kind and description”, Art. 24(3) of the treaty referred to “any taxation”. The Lower Court of s’Hertogenbosch had ruled that the non-discrimination clause should apply to the Dutch capital tax because it prohibits discrimination with respect to “any taxation”, whereas the provision on substantive scope referred solely to taxes on income.

Advocate-General Wattel supported this position, stating that a restrictive interpretation of the non-discrimination clause is not in accordance with the purpose and intention of the treaty. However, the Supreme Court took a restrictive approach with a view to the fact that a provision similar to Art. 24(6) of the OECD Model was missing, disregarding the broad reference in Art. 24(3) of the treaty to “any taxation”.

While it is generally accepted that the omission of a statement in the sense of Art. 24(6) leads to the confinement of the non-discrimination clause to the substantive scope of the treaty, the reference to “any taxation” in the Canada–Netherlands treaty at issue nevertheless can be seen as a clear indicator of a broad objective intent, which is why the Court’s oblivion of this formulation has met with heavy criticism.<sup>533</sup> The Court’s decision lacks a sound basis and appears to signify the attempt of a domestic court to undermine the purpose of the non-discrimination provision to guard against discriminatory practices on the broadest possible scale, as evinced by the wording “any taxation”. Treaty application in good faith requires a purposive approach to the concept of tax in the non-discrimination article.

The Commentaries, however, do not specify how broad the scope of the non-discrimination article is intended to be. The Technical Explanation to Art. 2 of the US Model Tax Treaty stresses that “[a] broader coverage applies, however, for purposes of Articles 24 (Non-Discrimination)”, in that this article “applies with respect to all taxes, including those imposed by state and local governments”,<sup>534</sup>

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discrimination article in the Nordic Convention, see Helminen, “Non-discrimination and the Nordic Multilateral Double Taxation Convention”, *Bulletin for International Taxation* 2007, pp. 103 et seq.

<sup>527</sup> Commentary to Art. 24 of the 2005 Income and Capital MC, m.no. 72.

<sup>528</sup> Raupach, “Diskriminierungsverbote und Gleichbehandlungsklauseln in Doppelbesteuerungsabkommen”, AWD 1966, p. 87.

<sup>529</sup> Debatin, “Das Verbot steuerlicher Diskriminierung”, DStZ 1970, p. 132.

<sup>530</sup> See Adonnino, “General Report”, IFA *Cahiers de droit fiscal international* Vol. 78b, p. 38. See also K. Vogel, Commentary on Art. 24, m.no. 2; van Raad, *Non-Discrimination in International Tax Law* (1986) p. 202.

<sup>531</sup> Canada–Netherlands Income Tax Treaty (as amended by the 1997 Protocol) of 27 May 1986, effective 1 January 1987.

<sup>532</sup> Netherlands Supreme Court, P.N.D., Case No. 35.398, decision of 1 November 2000; discussed by Offermanns, “Non-Discrimination Clause in Canada-Netherlands Tax Treaty Not Applicable to Capital Duty – Decision of the Supreme Court of 1 November 2000”, *European Taxation* 2001, pp. 106 et seq.

<sup>533</sup> See the considerations of De Bont, “Tax Treaty Interpretation in the Netherlands”, in M. Lang (ed.) *Tax Treaty Interpretation* (2001) pp. 241 et seq., as well as the criticism of Offermanns, *European Taxation* 2001, pp. 106 et seq.

<sup>534</sup> US Model Technical Explanation accompanying the US Model Income Tax Convention of November 15, 2006, explanation to Art. 2, introductory passage.

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which clearly broadens the scope of Art. 24 as opposed to Art. 2, as the latter only covers federal taxes.

The OECD Model Commentary does not take a stand on whether a broader scope can be assumed for Art. 24 than is foreseen in Art. 2; it is merely reiterated that Art. 24 “applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.”<sup>535</sup> Van Raad advocates instant reference to domestic law under Art. 3(2), as

[d]ifferent from Article 2, the OECD Commentary on the Articles 24, 26 and 27 does not provide any further clue as to the meaning of the term ‘tax’ used in these Articles. Therefore, any government levy that is considered a ‘tax’ under the domestic (tax) law of the treaty states is included in the scope of these Articles.<sup>536</sup>

This view is not followed in the present thesis; as will be laid out in the following, further insights as to the meaning of “taxes of every kind and description” can be gained from the context of the treaty.<sup>537</sup>

The present wording of Art. 24 dates back to the 1958 draft version of WP No. 4 of the OEEC Fiscal Committee.<sup>538</sup> The Commentary provided by WP No. 4 states with respect to para. 6:

This paragraph states that the word ‘taxation’ used in the preceding paragraphs of the articles means taxes of every kind and description levied by or on behalf of the state, its political and administrative subdivisions, or any institutions or agencies whatsoever. It does not call for any special comment.<sup>539</sup>

This speaks for the assumption that the provision is intended to encompass the widest possible spectrum of taxes.

Prior to the adoption of para. 6, the scope of the term “taxation” in para. 1 of the Draft Article on non-discrimination was subject to discussion: in a Supplementary Report of 1957, Working Party No. 4, in response to written comments submitted to it by the Belgian, Swedish and Swiss Delegations, elaborated with respect to the envisaged article on tax discrimination:

The Article proposed by the Working Party relates to taxes on income, on capital, on estates and inheritances and on gifts. The Swiss Delegation has suggested that this limitation should not be sustained but that taxes and contributions in general should be covered ... by the use of the term ‘taxation’, subject to this term being defined in an additional clause, as follows: “In this Article the term ‘taxation’ means contributions of every kind and description levied by any authority whatsoever.” In principle, the Working Party’s view is that the aim should be to prevent discriminatory treatment in relation to all taxes whatsoever. It feels, however, that it must leave to the Committee’s judgment the question whether such a widely drawn provision should be adopted, and it has restricted itself in its draft to the taxes which have so far been discussed in the Committee.<sup>540</sup>

The Committee consented to the proposal of the Swiss Delegation:

After a discussion on the field of application of the draft Article, the Committee decided that paragraph 1 ought to apply to taxes and contributions in general, as proposed by the Delegate for Switzerland supported by the Delegate for Denmark.<sup>541</sup>

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<sup>535</sup> Commentary to Art. 24(6) of the 2005 Income and Capital MC, m.no. 60. See also the 1982 Commentary to Art. 10(4) of the Estates, Inheritances and Gifts MC, m.no. 23.

<sup>536</sup> Van Raad, Paper for the 9th Annual EATLP Meeting (2005) p.6.

<sup>537</sup> See especially with respect to the drafting history of Art. 24 the elaborations by M. Lang, “Die Arbeiten der OEEC und der OECD zur Schaffung der Diskriminierungsverbote”, in Lang/Schuch/Staringer (eds.) *Die Diskriminierungsverbote im Recht der Doppelbesteuerungsabkommen* (2006) pp. 31 et seq.

<sup>538</sup> OEEC, WP No. 4 of the Fiscal Committee (Netherlands and France) Final Report on Tax Discrimination on Grounds of Nationality or Similar Grounds, FC/WP 4(58)1, Paris, 19 February 1958. The text was adopted by the Council that same year: OEEC Council, C(58)118 Part I Annex IV.

<sup>539</sup> FC/WP 4(58)1, II. Commentary on the Draft Art., p. 9.

<sup>540</sup> WP No. 4 of the Fiscal Committee, Supplementary Report on Tax Discrimination on Grounds of Nationality or Similar Grounds, FC/WP 4(57)2, Paris, 10 May 1957, pp. 1 et seq.

<sup>541</sup> OEEC, Minutes of the 4<sup>th</sup> Session of the Fiscal Committee, 4-7 June 1957, FC/M(57)2, p. 3.

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Following this clarification by the Committee, WP No. 4 called on the Fiscal Committee to include an express clarification in this vein in the text of the provision:

In June, the Committee decided that the provisions for the prevention of discrimination should apply to taxes and contributions in general. The Working Party is of opinion<sup>542</sup> that this clarification should be inserted in a separate paragraph.<sup>543</sup>

Although this suggestion was never realized, the materials paint a clear picture of the object and purpose of Art. 24 to cover any and all levies that can be qualified as taxes.

With respect to taxes on estates and inheritances, WP No. 4 noted that “only very little discrimination arises in connection with these taxes.”<sup>544</sup> In 1963, in the context of drafting a Model Convention with respect to the taxation of estates and inheritances, the scope of the word “taxation” in the non-discrimination provision corresponding to Art. 24 of the Income and Capital MC did not give rise to a lot of discussion. The Delegate for Switzerland proposed that the scope of the term “taxation” should be seen to be identical with the term as already adopted in the draft Convention on Income and Capital;<sup>545</sup> this view was followed throughout the further drafting process of the Estates and Inheritances Tax Model Convention.<sup>546</sup>

Clarity in this respect had been attained much earlier; the Commentary to the provision on Equality of Treatment in the Draft Model Tax Conventions of Mexico and London stated: “There is no doubt that these provisions are also intended to apply, *mutatis mutandis*, to the taxes on property, capital or increment of wealth..., though this is not specifically stated in the Model Convention.”<sup>547</sup>

In drafting the Income and Capital MC of 1977, WP No. 4 sent out a questionnaire on the interpretation of Art. 24 to the Representatives of the OECD Member States.<sup>548</sup> With regard to Art. 24(6), the following feedback was received:

The Austrian Delegation considers that the scope of Article 24 should be restricted to the taxes to which the Convention applies and that paragraph 6 of that Article should be deleted accordingly. In contrast, the Spanish Delegation would like it made clear that the term “taxation” covers taxes of every kind, including those not governed by the convention. The Swedish Delegation, for its part, suggests merely that a discussion be held on this point, in order to determine once and for all what taxes are covered by the term ‘taxation’.<sup>549</sup>

WP No. 4 believed it impossible to make changes to the Model text on account of the diversity of opinions among the Delegates: “It appeared to the Working Party that it was not possible, at present, to consider the majority of the amendments proposed by Member countries... [I]t has been seen above that the Member countries expressed conflicting views on the majority of them.”<sup>550</sup>

The purpose of Art. 24 to infuse equity into tax treaty law is best effected when it is independent of the mutual bargaining of the treaty partners. Any burden that qualifies as a “tax” under domestic law is within the umbrella of discrimination protection of a tax treaty, irrespective of the scope of taxes covered agreed upon by way of a mutual compromise.

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<sup>542</sup> Sic.

<sup>543</sup> OEEC, WP No. 4 of the Fiscal Committee, Second Supplementary Report on Tax Discrimination on Grounds of Nationality or Similar Grounds, FC/WP 4 (57)3, Paris, 13 September 1957, p. 14, under the heading “Paragraph (6) – Field of Application of the Provisions as Regards Taxes”.

<sup>544</sup> OEEC, FC/WP 4(57)1, Paris, 11 January 1957, p. 4.

<sup>545</sup> OECD, Fiscal Committee, Minutes of the 10th Session, Paris, 14-17 May 1963, FC/M(63)4, p. 5.

<sup>546</sup> OECD, Fiscal Committee, Draft Report to the Council on the Draft Double Taxation Convention on Estates and Inheritances, FC(66)1, Paris, 16 March, 1966.

<sup>547</sup> League of Nations, Fiscal Committee, London and Mexico Model Tax Conventions – Commentary and Text, Geneva, November 1946, Ad Art. XVI.

<sup>548</sup> OECD, WP No. 4 of the Fiscal Committee (France-Japan-Spain) Questionnaire on Art. 24 (Non-Discrimination) of the OECD Draft Convention for the Avoidance of Double Taxation, FC/WP 4(68)1, Paris, 15 October 1968.

<sup>549</sup> OECD, WP No. 4 of the Fiscal Committee (France-Spain-Japan) Report on Amendments Which Might Be Made to Article 24 of the Draft Convention Relating to Non-Discrimination, FC/WP 4(69)1, Paris, 21 November 1969, p. 12.

<sup>550</sup> Id., at p. 15.

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### 2.3.2. Provisions on exchange of information and assistance in the collection of taxes

In addition Art. 2(4), which provides that the treaty partners shall notify each other of significant changes in domestic tax laws that may affect treaty application,<sup>551</sup> most treaties contain a provision for reciprocal exchange of information upon request of the tax authorities of either treaty partner. Art. 26 of the OECD Income and Capital MC deals with international exchange of information between the tax authorities of the contracting parties. Although the Convention generally applies only to residents of one or both of the contracting parties, this article does cover the exchange of information relating to persons who are not residents of either of the treaty partners.

Moreover, information may be requested by either party with respect to “taxes of every kind imposed by a contracting state”, i.e. not only the taxes otherwise covered by the treaty under Art. 2. For example, the competent authority of a contracting party may request information used in examining an estate tax return even though the substantive scope of the treaty does not encompass estate taxes.

The current OECD Art. 26 is identical in wording with the corresponding provision in the US Model, which has been applied to any information relevant to carrying out the provisions of the treaty or the domestic laws of either contracting party.<sup>552</sup>

The idea for standardized reciprocal exchange of information was developed by the Technical Experts of the League of Nations, who commented in their 1925 Report to the Fiscal Committee: “Our investigation into the question of double taxation and the few treaties existing between some of the European States has suggested to us the idea of the exchange of information on taxation matters, an idea which has been clarified and defined in the course of our deliberations.”<sup>553</sup> The Experts further noted: “What will be the scope of the information to be given? Here we have drawn no distinction between the various taxes and have merely reviewed the various categories of wealth or income which a taxpayer may possess.”<sup>554</sup>

The provision on exchange of information was from its inception thus seen to tie in with the substantive scope of the treaty and limited to matters of taxes on income and capital. The 1963 OECD Model adopted this approach in providing that the parties “shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is in accordance with this Convention.”<sup>555</sup> The Model Commentary read: “In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the national tax in question is covered by the Convention....”<sup>556</sup>

In an observation on the Commentary, Mexico and the United States clarified that they reserved the right to “extend the application of this Article to all taxes imposed by a Contracting State, not just taxes covered by the Convention pursuant to Article 2.”<sup>557</sup>

A revision of the OECD Model in 2000 broadened the reach of Art. 26: contracting parties adopting the revised wording can exchange information under the treaty as to “taxes of every kind and description”, a formulation that had been in use in the 1981 U.S. Model.

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<sup>551</sup> See the discussion of Art. 2(4) *supra* at II.5.

<sup>552</sup> See e.g. US Department of the Treasury Press Release hp-1076 of 10 July 2008, in the context of proposed new treaties with Bulgaria, Canada and Iceland.

<sup>553</sup> League of Nations, Double Taxation and Tax Evasion, Report and Resolutions, Submitted by the Technical Experts to the Financial Committee of the League of Nations, Geneva, 7 February 1925 (F.212) Part I.

<sup>554</sup> *Id.* at III.2.

<sup>555</sup> Art. 26(1) of the 1963 OEEC Income and Capital MC.

<sup>556</sup> Model Commentary to Art. 26 para. 1, m.no. 5 as it read from 1963 up to the revision of the Model in 2000.

<sup>557</sup> Observation on the Model Commentary to Art. 26 para. 1, m.no. 25.

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Further explanations were inserted in the 2005 Model Commentary:

[T]he present Article embodies the rules under which information may be exchanged to the widest possible extent, with a view to laying the proper basis for the implementation of the domestic laws of the Contracting States concerning taxes covered by the Convention and for the application of specific provisions of the Convention. The text of the Article makes it clear that the exchange of information is not restricted by Articles 1 and 2, so that the information may include particulars about non-residents and may relate to the administration or enforcement of taxes not referred to in Article 2.<sup>558</sup>

Customs duties are the only charges explicitly excluded from the broad reach of Art. 26: the Model Commentary notes that exchange of information with respect to customs duties “has a legal basis in other international instruments.”<sup>559</sup> With respect to social security levies, the situation is unclear. On the basis of conclusions earlier in this study on the nature of social security contributions, the following is proposed: Where a social security levy can be seen to be a “tax” as per Art. 2, it is certainly covered under the broad reference to “taxes of every kind and description.” This is the case where a country finances social security predominantly out of general taxation.

On the other hand, where there is a closed system of contributions and corresponding benefits, such levies clearly come within the realm of social security totalization agreements. However, they may still come within the exchange of information provision of a tax treaty if this is in line with the object and purpose of both international instruments. Para. 5.2 of the 2005 Commentary to Art. 26 is a verbatim transcription of Art. 27(1) of the OECD/Council of Europe Convention on Exchange of Information, the 1989 Technical Explanation to which reads:

The Convention also covers compulsory social security contributions paid to social security agencies governed by public law, even if the latter do not, strictly speaking, constitute general governmental departments. What is important in this case is the nature of the contribution, whereas the structure or method of operation of the agency managing the service in question is immaterial for the purpose of the instrument. On the other hand, compulsory contributions to private law institutions do not fall under this instrument even if the said institutions are under public inspection.<sup>560</sup>

Given this history of Art. 26, the conclusion can be drawn that irrespective of whether there are other instruments for administrative cooperation in the field of social security, Art. 26 applies to social security contributions as this article is not limited by other international instruments. In countries where the administration and collection of taxes and social security levies, respectively, is allocated to different governmental entities or bodies, practical results ultimately hinge upon the coordination of competences under domestic laws.

It remains unclear whether fees, i.e. payments directly in exchange for public services, are encompassed by information exchange. In line with the above deliberations on the concept of “tax”, arguably such payments are not “taxes” and are therefore not addressed by the reference in Art. 26 to “taxes of every kind and description.” Based on the considerations earlier in this study on grey areas between taxes and fees, it can be concluded that payments made to general revenue without a corresponding benefit will come within the “taxes of every kind and description” aimed at in Art. 26.

The same conclusions apply to Art. 27, which provides for assistance in the collection of taxes. Art. 27 was added as an entirely new provision in the OECD Income and Capital MC in January 2003.<sup>561</sup> Prior to its inclusion in the Model text, contracting parties had sporadically included a provision referring to assistance in collection; the earliest example seems to be the income and capital tax treaty concluded between Germany and Italy in 1925, which provided in its Art. 18: “The Contracting Parties undertake to assist each other reciprocally in levying and collecting direct taxes. The manner in which such assistance is to be given shall be defined in a separate convention.” The 1927 League of

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<sup>558</sup> Preliminary remarks to the 2005 MC Commentary on Art. 26 para. 1, m.no. 2.

<sup>559</sup> 2005 OECD Model Commentary on Art. 26 para. 1, m.no. 5.2.

<sup>560</sup> Para. 25 of the 1989 Technical Explanation to the OECD/Council of Europe Convention.

<sup>561</sup> See further Végh, “The 2003 OECD Model”, *European Taxation* 2003, pp. 244 et seq.

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Nations draft texts contained a Draft Bilateral Convention on Judicial Assistance in the Collection of Taxes,<sup>562</sup> which provided:

Article 1: The Contracting States undertake to give each other mutual assistance in the collection of the following taxes [Footnote1]: (a)..., (b)..., (c)... Article 2: The assistance in question shall apply both to the principal of the tax and to charges incidental thereto (costs, interest) [Footnote2].

Footnote 1: The Contracting States shall decide in agreement with one another whether the Convention is applicable to State taxes only or to provincial, communal and other taxes also. Footnote 2: Penalties of a fiscal nature, etc., may also be inserted.

The Commentary to Art. 1 of this Draft stresses: “The taxes which it is desired to collect will be enumerated, so that no doubt will exist as to the scope of the Convention. Moreover, this method enables States to include . . . , if they deem it desirable, all kinds of taxes in addition to direct taxes.”

The drafters of Art. 27 of the OECD Model made a conscious choice not to refer to “taxes”, but to rather speak of an obligation of the contracting parties assist each other in the collection of “revenue claims”. The term is defined as encompassing all amounts owed in respect of taxes, as well as interest, administrative penalties, and costs of collection or conservancy related to such amounts.<sup>563</sup>

Assistance between the contracting parties is not restricted by Arts. 1 and 2: the revenue claims concerned do not need to be made from persons who are residents. The term “revenue claim” as defined in Art. 27(2) covers all amounts owed in respect of all kinds of taxes imposed on behalf of the state, its subdivisions or local authorities, and not merely the taxes envisaged in Art. 2. The definition also includes interest on unpaid tax, administrative penalties and the costs of collection or conservancy. Moreover, Art. 27 is not expressly limited to taxes which fall due after the treaty enters into force. This article might thus potentially have an element of retrospective application to taxes which have fallen due before the convention was concluded or entered into force.<sup>564</sup>

Not only is assistance in the collection of taxes under Art. 27 not limited by Art. 2, but assistance is permitted even with respect to taxes that do not exist in the country receiving the request for assistance.<sup>565</sup> The purpose of facilitating the collection of revenue claims by the treaty partner’s government is independent of the taxes covered by the respective treaty. Art. 27 can thus be seen to cover interest, administrative penalties and any other costs whose collection would otherwise be frustrated.

## **B. Taxes on income and on capital**

“The only decisive fact for the application of the Convention to a given tax is that the basis on which this tax is levied is considered to be ‘income (capital)’.”<sup>566</sup>

The foundational premise of domestic income tax systems and the application of income tax treaties alike is to conceptualize items that constitute income and capital for tax purposes. Certain items may be classified as “income” under the tax laws of one treaty partner but not the other; therefore, when applying a treaty covering “taxes on income” as between two countries, it is key to determine whether a certain taxable item can be considered “income” subject to taxes within the scope of the treaty.

### **1. The concept of income in tax treaties**

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<sup>562</sup> League of Nations, Double Taxation and Tax Evasion, Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, G.216.M.85.1927.II, Geneva, April 1927, IV.

<sup>563</sup> Further Baker, Commentary on Art. 27, 27B-01 et seq.

<sup>564</sup> Para. 14 of the OECD Model Commentary; see also Baker at 27B-04.

<sup>565</sup> Para. 18 of the OECD Model Commentary to Art. 27.

<sup>566</sup> FC/WP 30(69)1, m.no. 17 (emphasis in the original).

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Income tax is the internationally most widespread form of taxation. However, centuries of debate in economic fiscal theory have illustrated that the contours of a possible universal concept of income are murky, if not altogether elusive. The objective of the following considerations is to seek a route towards the practical application of a basic concept of income in resolving possible points of contention among contracting parties.

Drawing on practical examples, the question to be answered is whether it is useful in the light of the object and purpose of income tax treaties to see the application of income tax treaties as being founded on a comprehensive, all-encompassing concept of income. The core question in this context is whether the domestic classification of taxes as “taxes on income” is determinative in the application of tax treaties.

### **1.1. The schedular system of tax treaties**

At the early stages of development of the League of Nations Model Conventions ultimately leading to the OECD Model texts, a considerable number of countries used a schedular rather than a global approach in their domestic income tax systems. A schedular income tax system is one in which separate taxes are imposed on different categories of income, while in a global income tax system, a single tax is imposed on all income, whatever its nature.<sup>567</sup>

The Model Conventions have taken what could be called a “basket approach”, with different types of income and capital dealt with under the respective distributive articles. This schedular nature of the Model Conventions has been a fixture in tax treaties. It has recently faced criticism and calls for reform, however. Vogel has argued that the types of income in the Model texts and in existing treaties follow no logical order or systematic conception.<sup>568</sup> This tax treaty structure gives rise to conflicts of classification in that the “income baskets” do not seem to be clearly mutually exclusive. Rosenbloom, on the other hand, has questioned whether there is a persuasive case for radical change in the way tax treaties are constructed.<sup>569</sup>

While the depths of this issue are beyond the scope of the present study, it allows for an important conclusion as to the concept of income in tax treaties: Art. 2 contains a very broad global definition of the income items to which the treaty applies. The main reason the Model texts allocate income in a schedular manner seems to be to enable a case-by-case compromise between capital importing and capital exporting countries.<sup>570</sup> It seems there is only a very basic common notion of income underlying the Model texts; whatever a country’s domestic system declares to be a certain type of income seems to be covered under the respective “basket” in the treaty. This will be further examined below in an analysis of the treatment of income fictions under tax treaties. In a first step, common features of the basic concept of income are elicited from the system adopted in treaties following the OECD Model text.

### **1.2. Basic common consensus on the concept of income**

Most domestic tax systems do not define income as clearly as one would expect;<sup>571</sup> existing definitions are usually very broad. In the United States, Sec. 61 of the Internal Revenue Code plainly

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<sup>567</sup> See further Lee Burns/Richard Krever, “Individual Income Tax”, in Victor Thuronyi (ed.), *Tax Law Design and Drafting* (1998) Chap. 14.

<sup>568</sup> Vogel, “The Schedular Structure of Tax Treaties”, *Bulletin for International Fiscal Documentation* June 2002, 260 (260).

<sup>569</sup> Rosenbloom, “Comments on the Schedular Structure of Tax Treaties”, *Bulletin for International Fiscal Documentation* “Tax Treaty Monitor” June 2002, p. 262.

<sup>570</sup> See also Genschel/Rixen, “International Tax Cooperation and National Tax Sovereignty”, conference paper (2005), on file with the author.

<sup>571</sup> Yarif Brauner, “An International Tax Regime in Crystallization”, *56 Tax Law Review* (2003) 259.



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defines gross income as income from any source.<sup>572</sup> The US Supreme Court, in the classic and oft-cited decision *Commissioner v. Glenshaw Glass*, defined income as (1) accession to wealth, (2) that is clearly realized and (3) over which the taxpayer has complete dominion.<sup>573</sup>

Legislative authority then has the “power to condition, limit, or deny deductions from gross incomes in order to arrive at the net that it chooses to tax.”<sup>574</sup> These basic maxims appear to hold true in most income tax systems.

With a view to the basic maxims of income taxation in the various countries, Thuronyi has noted: “The degree of commonality in income tax is striking”<sup>575</sup> Income tax regimes in the various countries generally adopt the Schanz/Haig/Simons economic definition of income, named after early 20<sup>th</sup> century economists advocating its use as the most accurate reflection of the taxpayer’s economic capacity, i.e. “ability to pay”. Under this definition, income is the money value of the net accretion to one’s economic power between two points of time.<sup>576</sup> Some countries expressly invoke the ability-to-pay principle of taxation in their constitution as a limitation on the government’s power to tax.<sup>577</sup>

Austrian scholar Hans Georg Ruppe proffered the fundamental observation that cash-basis market transactions are the primary focus of income taxation.<sup>578</sup> Non-market and/or non-cash economic activity is regularly excluded from the notion of income in domestic tax systems. This phenomenon can thus be seen as a basic guiding principle in conceptualizing the notion of income in a domestic as well as in the international context.

The concept of income in tax treaties is to be viewed from its international context as well as from the perspective of the object and purpose of tax treaties and the functioning of the treaty as an expression of mutual agreement.

Vogel argued that equity in taxation in the international context has the same conceptual underpinnings as domestic equity in taxation.<sup>579</sup> This view has been criticized in that taxation of income in the domestic context is to be distinguished from the sharing of interests in international income.<sup>580</sup> Nevertheless, Vogel’s basic approach is sound; the object and purpose of tax treaties points to a concept of income that ties in with the concept of income as a tax base in the respective country.

While the Schanz/Haig/Simons principle of income as “accession to wealth” generally encompasses also unrealized gains, most income tax systems provide for a basic realization requirement as an indication of taxpayers’ ability to pay.<sup>581</sup> Nevertheless, income taxes throughout the nations are predominantly “hybrids”: frequent abandonment of realization in favour of mere accretion can be found where certain easily valued assets are “marked to market” or, in the context of taxation of

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<sup>572</sup> Sec. 61 IRC (“Gross income defined”) reads: “(a) General definition – Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services ...; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends....”

<sup>573</sup> *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

<sup>574</sup> *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 381 (1934); *Helvering v. Windmill*, 305 U.S. 79, 84 (1938).

<sup>575</sup> Victor Thuronyi, “Introduction”, in Victor Thuronyi (ed.) *Tax Law Design and Drafting* (1998).

<sup>576</sup> See Henry C. Simons, “Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy” (1938) 50: “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” A general treatise on the significance of economic concepts in domestic tax law and in the tax treaty context is given by Louan Verdoner, “Major Economic Concepts in Tax Treaty Policy”, 31 *Intertax* 147 (2003).

<sup>577</sup> Examples of explicit reference to the ability-to-pay principle can be found in the constitutions of Italy, Spain and Germany.

<sup>578</sup> See also Ruppe’s considerations in “‘Übertragung’ – Möglichkeiten und Grenzen der Übertragung von Einkunftsquellen als Problem der Zurechnung von Einkünften”, in Tipke (ed.) *Übertragung von Einkunftsquellen im Steuerrecht* (1978) 7 et seq. See further Rolf Wittmann, *Das Markteinkommen* (1992).

<sup>579</sup> Klaus Vogel, “World-wide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part 1)”, *Intertax* (1988) 216.

<sup>580</sup> See Nancy H. Kaufman, “Fairness and the Taxation of International Income”, 29 *Law and Policy in International Business* (1998) 145 et seq.

<sup>581</sup> See Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis*, IBFD Publications (2001) 16.

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interest, “deemed accrued” in interest-free loans.<sup>582</sup> Income has been held to imply dominion or control of the taxpayer over the amount received.<sup>583</sup>

The notion of ability to pay thus remains unclear even in the international context.<sup>584</sup> However, it may certainly serve as a starting point in gauging items of income allocated under tax treaties. It is an integral part of the commonality in domestic tax provisions that there is a myriad of exceptions to the basic taxation principles, a major part of which are effected by way of what could be called “income fictions”. The following deliberations deal with these most common “deviations” from what could be seen as a basic common concept of income underlying underlie income tax treaties. Upon conclusion of this practical analysis, the thesis goes on to delimit the concept of taxes on income from that of taxes on capital. This distinction is relevant since a considerable number of treaties apply solely to taxes on income because at the time of conclusion of the treaty neither contracting state levies “taxes on capital”.

### 1.3. “Fictitious income” in tax treaties

Rosenbloom stated that “it would be practically impossible for any jurisdiction to disregard fictions altogether in shaping its rules of taxation.”<sup>585</sup>

When a country presumes that there is income to a taxpayer and levies taxes accordingly, should the tax levied on such “fictitious” income be given effect also in applying bilateral income tax treaties concluded by that country? The analysis of this seemingly simple, yet unresolved, practical question may shed more light on the concept of income in tax treaties.

Discrepancies in income tax systems in terms of taxing a notional or actual increase in wealth may lead to double taxation in cross-border situations. Where one country taxes fictitious income, while another country characterizes taxable income differently, questions arise as to the extent to which income tax treaties provide relief. The treaty provisions allocate taxing rights with respect to specified items of income “paid” or “derived”, so that one could call into question their application to situations where income is deemed to be paid or derived by the taxpayer under domestic law. On these grounds, it has been argued that domestic “income fictions” are not covered by the specified allocation provisions, but rather fall under the residual “Other Income” article (Art. 21).<sup>586</sup>

In contrast, the basic approach taken in this thesis is that income tax treaties are in principle indifferent as to whether the taxable event is “fictitious”, as treaty protection ties in with domestic tax burdens.

#### 1.3.1. Income fictions in domestic tax systems

The term “fictitious income” as used in the following is intended to describe situations that involve no determinable or measurable increase in wealth to the taxpayer. The premise taken is that no solid distinction is possible between full-fledged fictions, where there is no actual money income stream, and mere “approximations of reality” where governments assume or calculate taxable income for the simple reason that any actual shift of economic power is hard to measure. Arguably, “every actual

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<sup>582</sup> See, for example, Sec. 1256 of the US IRC, as well as the provisions for “original issue discount” in Sec; 1273 IRC.

<sup>583</sup> *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972).

<sup>584</sup> Cf. the criticism in Deborah A. Geier, 3Time to bring back the ‘benefit’ norm?”, *Tax Analysts Worldwide Daily* February 2004, 41.

<sup>585</sup> David H. Rosenbloom, “Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt”, 26 *Sidney Law Review* (2004) 17 (19).

<sup>586</sup> See Peter J. Wattel/Otto Marres, “Characterization of Fictitious Income under OECD-Patterned Tax Treaties”, *European Taxation* (2003) 66.

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advantage (every increase in wealth, every shift or increase in property, including unrealized capital gains)” should be treated differently from “fictitious earnings and fictitious capital increases”.<sup>587</sup>

However, it is virtually impossible to draw a bright line between “fiction” and “reality” in the context of the income tax; notional approximations to a taxpayer’s income will often not correspond to market prices and may thus be far from reality.<sup>588</sup> More generally, one could call into question whether there is such a thing as “real income” for purposes of the income tax. A common feature of income tax systems across the nations appears to be the fact that taxable income is derived by way of exemptions, legal presumptions, accelerations and deferrals, almost to a point where one could view income tax provisions as the most imaginative fiction ever written. In fact, it seems like an inherent characteristic of tax laws that they are abundant with fiction.

In the following, some examples are presented that display what could be characterized as fictitious taxable income in domestic tax laws. These examples will serve as a backdrop to all further analyses regarding the treatment of “income fictions” under income tax treaties.

### **1.3.1.1. Imputed interest, imputed income from owner-occupied housing**

Imputed income has been defined as “a flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf.”<sup>589</sup> A distinguishing characteristic of imputed income is treated as if it were derived in the ordinary processes of the market.

In a dispute between the United States and Canada, imputed interest on the taxpayer’s sale of stock interest for a non-interest bearing note was upheld at the reduced tax treaty rate. The treaty and protocol thereto were seen not to preclude the United States from taxing imputed interest income under its domestic tax law (IRC Sec. 483). The US Tax Court noted in its analysis that income under the tax treaty includes interest and that the term “interest” is not defined exhaustively in either the treaty text or the Protocol, as the wording in the Protocol provided that “‘interest’ ... shall include....”<sup>590</sup>

The taxation of owner-occupied housing is frequently cited as the prime example for imputed income; imputed rental income was in fact explicitly included in treaties from the 1930s onwards.<sup>591</sup> Although the taxation of net imputed income to homeowners is a commonly invoked demand in terms of tax policy,<sup>592</sup> most countries do not impose taxes on such personal dwellings. Currently, however, OECD countries such as Belgium, Denmark, Greece, Italy, Luxembourg, the Netherlands, Norway, Spain and the United Kingdom tax homeowners on imputed income to varying degrees.<sup>593</sup> In Europe,

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<sup>587</sup> Wattel/Marres, *European Taxation* (2003) 66 (67).

<sup>588</sup> See the considerations of M. Lang, “‘Fictitious Income’ and Tax Treaties”, in Arendonk/Engelen/Jansen (eds) *A Tax Globalist - The Search for the Borders of International Taxation, Essays in Honor of Maarten J. Ellis* (2005) 34.

<sup>589</sup> Laurie L. Malman/Linda F. Sugin/Lewis D. Solomon/Jerome M. Hesch, *The Individual Tax Base – Cases, Problems and Policies in Federal Taxation* (2002) 136.

<sup>590</sup> US Tax Court, *Crow v. Commissioner*, decision of August 26, 1985, 85 TC 376.

<sup>591</sup> See Annex II for the following treaties: Belgium–France 1931, Belgium–Italy 1931, France–Italy 1931, Belgium–Netherlands 1933.

<sup>592</sup> For the United States, see the arguments made by James R. Follain/David C. Ling/Gary A. McGill, “The Preferential Income Tax Treatment of Owner-occupied Housing: Who Really Benefits?”, 4 *Housing Policy Debate* 1 (1993); Steven C. Bourassa and William G. Grigsby, “Income Tax Concessions for Owner-Occupied Housing”, 8 *Housing Policy Debate* 3 (2000) 521. Although not part of the tax base in the United States, income from owner-occupied housing is imputed by the US Department of Commerce in estimating gross domestic product.

<sup>593</sup> See further OECD, *Economic Survey of the Euro Area 2005: Illustrative Estimates of the Impact of Owner Occupied Housing costs on inflation*. See also the data provided in International Bureau of Fiscal Documentation (IBFD) *Supplementary Service to European Taxation*, IBFD, Amsterdam (2005).

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approximately two thirds of the households own the dwellings that they occupy and the share of owner-occupied dwellings has been on the increase.<sup>594</sup>

An illustrative example is the Spanish deemed rental income tax (*Rendimientos del capital inmobiliario*), which is levied on real estate that is neither rented out nor used as a primary residence. The Spanish local authorities in such cases presume rental income amounting to 2% of the ratable value (*valor catastral*) of the Spanish property and a tax of 25% is imposed on this “income”, equal to 0.5% of the *valor catastral*.

To give an example: When owning Spanish property with a *valor catastral* of EUR 100,000 and not renting it out, the taxpayer will still be liable to pay 25% of EUR 2,000 in income taxes.<sup>595</sup> There is no actual money income stream; homeowners are taxed on “non-cash income” regardless of the existence of any liquid funds.

While it is questionable whether such a tax is in line with the ability-to-pay principle, it demonstrates the fundamental leeway countries have in exerting tax sovereignty within the realm of the income tax. As tax treaties tie in with existing tax burdens and are not concerned with taxation principles like ability to pay to justify taxation, a tax levied on “income” per domestic law that does not entail measurable accretion to wealth will be within the substantive scope of the treaty unless the parties state otherwise or either party could, by way of treaty application in good faith, expect otherwise.

### **1.3.1.2. Provisions on controlled foreign companies**

Most countries have enacted provisions regarding controlled foreign companies (CFCs).<sup>596</sup> The policy rationale for such legislation is to prevent resident taxpayers from interposing foreign corporations in low-tax jurisdictions to derive income in this way instead of remitting it to the home country. CFC regimes regularly provide that passive income of a CFC, e.g. interest and dividends received from investments in securities, is “deemed distributed” and therefore immediately taxable in the residence country – irrespective of whether actual payments are being made. Income that could just as easily have been earned by the parent company is treated as a deemed dividend to the parent. Taxes are thus levied on a notionally determined advantage from shares held in the non-resident entity.

The United States was the first country to introduce CFC legislation, often referred to as “Subpart F legislation”.<sup>597</sup> In 1962, when the US Congress enacted the Subpart F provisions taxing shareholders on undistributed profits of their controlled foreign corporations, there were concerns in both the House Ways and Means and the Senate Finance Committees that this violated the realization requirement laid down in the Supreme Court decision *Eisner v. Macomber*.<sup>598</sup> Various nations have since modelled their CFC legislation on Subpart F; constitutional requirements are seen to be met in that taxpayers have sufficient dominion and control over the undistributed funds to effectuate receipt of payments.

### **1.3.1.3. Minimum corporate income tax**

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<sup>594</sup> For an extensive comparative analysis with respect to EC Member States, see Peter M. van der Hoek and Sarah E. Radloff, “Taxing owner-occupied housing: Comparing the Netherlands to other European Union countries”, 7 *Public Finance and Management* 4 (2007) 393.

<sup>595</sup> For more on the Spanish tax on owner-occupied housing, see Raquel Arévalo and Javier Ruiz-Castillo, “On the Imputation of Rental Prices to Owner-occupied Housing”, 4 *Journal of the European Economic Association* 4 (2006) 830. See also Miguel-Angel Lopez-Garcia, “Housing, Prices and Tax Policy in Spain”, 6 *Spanish Economic Review* (2004) 29.

<sup>596</sup> For a comparative overview of CFC legislation existing in OECD Member countries see OECD, Working Party No. 2 on Tax Policy Analysis and Tax Statistics of the Committee on Fiscal Affairs, *Studies in Taxation of Foreign Source Income – Controlled Foreign Company Legislation* (2000).

<sup>597</sup> Subpart F, Part III of Chap. 1, Subchap. N of the US IRC.

<sup>598</sup> Marjorie E. Kornhauser, “The Story of Macomber: The Continuing Legacy of Realization”, in Paul C. Caron (ed.) *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* (2003) 90, with further references.

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Domestic taxes on a deemed minimum income amount currently exist primarily in corporate tax systems in Latin America; within Europe, a tax of this kind is levied on companies resident in Austria.<sup>599</sup> In Argentina, Peru and Colombia, taxes are levied on “minimum presumptive income” of corporations on a percentage of a company’s net assets.<sup>600</sup> In Peru, a marginal rate system is applied with rates varying from 0% to 0.5% depending on the net value of assets of the company; this tax can be credited against the regular corporate income tax. In Colombia, the presumptive corporate income tax is levied in the amount of 3% of a company’s net assets; the rate used to be 6%, but it was lowered in 2006 following heavy protests of companies. Colombia still applies the highest aggregate corporate tax rate throughout Latin America.<sup>601</sup>

A different approach is taken in Austria, where, aside from a regular corporate income tax rate of 25%, corporations sustaining losses have an obligation to pay taxes on presumed profits in the amount of 5% of the minimum statutory amount of registered capital as required under the Austrian law of corporations.<sup>602</sup> The current annual minimum tax is EUR 3,500 for public companies and EUR 1,750 for limited liability companies.<sup>603</sup>

Since this tax is creditable only against such corporate taxes in subsequent years that are paid on earnings exceeding the minimum capitalization requirement, the principle of ability to pay seems to be neglected: while the tax is creditable against corporate taxes paid upon profits made, there is no relief whatsoever from the burden of the minimum corporate income tax in the case that a company exclusively incurs losses.<sup>604</sup> The Austrian Supreme Court has upheld this tax on the grounds that it serves the sound policy goal to prevent an abuse of corporate form merely for tax purposes; the minimum tax is seen to function as the equivalent to interest that would have to be paid on long-term capital investment.<sup>605</sup>

#### 1.3.1.4. Notional personal income tax

In 2001, an unusual tax on presumed personal capital income<sup>606</sup> was introduced in the Netherlands that has been called “unique in the industrialized world”,<sup>607</sup> as it stands in stark contrast to the realization-based capital gains taxation prevailing in most countries. Capital income from personally held assets such as deposits, stocks and bonds is taxed in an amount equal to 4% of the net value of the underlying asset, subject to a flat 30% rate; any actual economic gains, losses, or expenses incurred are not taken into account.<sup>608</sup>

Notwithstanding the fact that this tax was enacted to replace the previously existing progressive tax on actual personal capital income, its character as an “income tax” could be contested. Although the express legislative intent was to create an income tax, this tax bears close resemblance in character to

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<sup>599</sup> For current data and analysis, see Jude Amos/Fraser Dickinson/Ephraim Fuks/Carlos Gutiérrez Puente/Juhani Kesti/Mei June Soo (eds), *Global Corporate Tax Handbook*, IBFD (2007).

<sup>600</sup> See fundamentally Richard M. Bird, “Tax Reform in Latin America: A Review of Some Recent Experiences”, 27 *Latin American Research Review* 1 (1992) 7; Charles E. McLure/John Mutti/Victor Thuronyi/George R. Zodrow, “The Taxation of Income from Business and Capital in Colombia”, in Malcolm Gillis (ed) *Fiscal Reform in the Developing World* (1990).

<sup>601</sup> For recent data, see Ephraim Fuks and Carlos Gutiérrez Puente (eds), *Latin America Tax Handbook*, IBFD (2007).

<sup>602</sup> The minimum statutory amount of capitalization in Austria is EUR 70,000 for public companies and EUR 35,000 for limited liability companies.

<sup>603</sup> See the recent figures in Austrian Business Agency, *Tax Aspects of Industrial Investment in Austria* (2007).

<sup>604</sup> For criticism in this vein in Austrian academic literature see Sabine Kirchmayr, “Mindestkörperschaftsteuer verfassungsrechtlich unbedenklich?”, *RdW* (1994) 364.

<sup>605</sup> Austrian Supreme Court (*Verfassungsgerichtshof*) B 138694, decision of 29 August 1994.

<sup>606</sup> The Dutch presumptive personal capital income tax (*vermogensrendementsheffing*) is incorporated in Arts. 5.2 and 7.7 of the 2001 Income Tax Act of the Netherlands.

<sup>607</sup> Sijbren Cnossen and Lans Bovenberg, “Fundamental Tax Reform in the Netherlands”, 7 *International Tax and Public Finance* (2001) 471.

<sup>608</sup> For a comprehensive analysis of this tax, see Henk Vording/Allard O. Lubbers, “The Netherlands Presumptive Income Tax on Portfolio Investment: Background, Aims and Effects”, *Bulletin for International Taxation* 2006, 327.

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net wealth taxes on the capital itself. Furthermore, its character is rare in that it is clearly not an attempt to approximate any actual income, but operates on the basis of a “pure fiction”.<sup>609</sup>

### 1.3.2. Inferences from the income allocation provisions

The allocation provisions with respect to the various items of income in the US Model Income Tax Treaty largely correspond to the provisions of the OECD Model in terms of their location in the treaty (Arts. 10 to 20) and their effects. What these allocation provisions have in common is that they consistently use the words “derived”, “paid”, and “payments”, which seems to indicate that “income fictions” are not covered. One could argue that “fictitious income” does not qualify as “income” as specified in the allocation provisions, as it is not actually “derived” or “paid”.

Wattel and Marres<sup>610</sup> have taken the position that income deemed to have been paid or derived under domestic law is to be subsumed under the “Other Income” provision (Art. 21 in both the US and the OECD Model Conventions); this article does not contain the language “paid” or “derived” but refers to “items of income beneficially owned by a resident of a Contracting State.”

While this argument appears to be sound under a literal reading of the treaty text, it is doubtful whether such an approach does justice to effective treaty application and to the very object and purpose of tax treaties. The residual “Other Income” Article gives exclusive taxing rights to the state of residence, which may give rise to inexpedient results in some cases. Moreover, some treaties do not contain an “Other Income” provision,<sup>611</sup> which would mean that there is no treaty protection despite a possible actual double tax burden.

On the grounds of what has been stated so far, the allocation provisions of tax treaties should be seen to cater to domestic income tax burdens. To adopt too literal a reading in determining whether income has been “paid” or “derived” not only hinders effective treaty application, but it would be inconsistent with the predominant basic concept of income in domestic tax systems worldwide. Stronger arguments speak in favour of subsuming “fictitious income” under the allocation provisions dealing with the specific subject matters instead of resorting to the “catch-all” provision laid down in Art. 21.

As stated at the outset, no feasible distinction is possible between “fiction” and “approximation of reality” for purposes of the income tax. While the allocation provisions concededly do not deal with “fictions”, the OECD Model Commentary does comment on the “calculation” of income, stating that the contracting parties retain full authority to determine the method of calculating items of income allocated to them.<sup>612</sup> Moreover, the Model Commentary to the article on interest (Art. 11) states that “the term ‘paid’ has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder...”,<sup>613</sup> while the Commentary on Art. 12 (Royalties) notes that “the word ‘payment’ ... has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor...”.<sup>614</sup>

Wattel and Marres interpret this to mean that “in any case a fulfilment of an obligation is required, or at least a real shift of assets or value from one taxpayer to another.”<sup>615</sup> The Commentary does not further elaborate, so it stands to reason whether an actual accretion to the taxpayer’s wealth or assets

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<sup>609</sup> Wattel/Marres, *European Taxation* (2003) 66 (78).

<sup>610</sup> Wattel/Marres, *id.*, at 66.

<sup>611</sup> Contracting parties will oftentimes find this article unnecessary; for a thorough analysis of Art. 21, see David A. Ward et al., “The Other Income Article of Income Tax Treaties”, 38 *Canadian Tax Journal* 2 (1990) 233.

<sup>612</sup> See m.no. 4 of the 2005 OECD Model Commentary on Art. 6 (Immoveable Property): “It should ... be noted that the provisions of the Article do not prejudice the application of domestic law as regards the manner in which income from immoveable property is to be taxed.” See also m.no. 28 of the Commentary to Art. 7 (Business Profits): “[E]ach country concerned would have to be given the right to compute the profits according to the provisions of its own laws.”

<sup>613</sup> M.no. 7 of the OECD Model Commentary on Art. 11.

<sup>614</sup> M.no. 8 of the OECD Model Commentary on Art. 12.

<sup>615</sup> Wattel/Marres, *European Taxation* (2003) 66 (68).

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is required. It is the view taken in this paper that this is not the case; to the contrary, the Commentary clearly conveys a functional approach.

A different interpretation may be warranted where the treaty text refers to the term “gain”: Art. 13 deals with gains from the alienation of property but no definition of the term is provided. A valid argument can be made that “gain” implies an actual shift in assets or wealth.<sup>616</sup> The allocation provisions speak of “payments” and of assets “put at the taxpayer’s disposal”, which calls for a broad reading.

The Commentary on Art. 10 (Dividends) further corroborates this purposive approach:

The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words ‘paid ... to a resident’ ... The term ‘beneficial owner’ is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.<sup>617</sup>

The above considerations allow for the conclusion that tax treaties are generally indifferent to any type of “income fiction” existing in a country’s domestic tax provisions. Unless the treaty parties have expressed their objective intent to the contrary, the adoption of the broad terminology as contained in the Model conventions warrants for “income fictions” to be treated as covered under the specified income allocation provisions. Protection from possible abuses is afforded by the general international legal principles of good faith and the permanency of commitments (*pacta sunt servanda*).

Moreover, if either of the contracting parties were to make changes to its income tax provisions after the conclusion of the treaty, there is a requirement in the last sentence of Art. 2(4) in both the US and OECD Models that “[t]he competent authorities of the Contracting States shall notify each other of any changes that have been made in their respective taxation or other laws that significantly affect their obligations under this Convention.” This will in most cases prevent newly introduced “fictions” from treaty coverage without the other party’s consent. Due to these workings of international law, and due to the fact that contracting nations will usually expect and be aware of elements of “fiction” in the treaty partner’s income tax system and make corresponding adjustments based on reciprocity, “fictitious income” will often not be a contested point under tax treaties. However, there is one aspect of “income fictions” that gives rise to double tax burdens without there being an adequate remedy under tax treaties; this problem may arise in cases involving a “timing mismatch”.

### **1.3.3. Fictitious income and timing mismatch – “exit taxes”**

A taxpayer may face problems of international double taxation where a domestic “income fiction” affects the timing of the taxable event. Where one country deems income to have been accrued to the taxpayer and levies taxes accordingly, any change in circumstances concerning the same taxable basis that leaves another state with taxing rights under a tax treaty may give rise to unrelieved double taxation. The latter country, disregarding any earlier taxation on the basis of “fictitious income” in the first country, is in full compliance with the treaty text upon taxing income that is “derived” under its domestic tax laws at this later point in time. Such economic double taxation due to a mismatch in the timing of taxable events effectively escapes the ambit of tax treaties.

Since income taxes are imposed as a function of the person producing the income, the transfer of residence of individuals and the change in tax jurisdiction this entails have led to problems in treaty application by the respective former and new residence states vying for taxing powers.

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<sup>616</sup> M. Lang, *Hybride Finanzierungen im Internationalen Steuerrecht* (1991) 102.

<sup>617</sup> M.no. 12 of the OECD Model Commentary on Art. 10(2).

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Countries have increasingly implemented deemed disposition rules to tax unrealized gains at the moment an individual or company transfers its residence or assets to another country.<sup>618</sup> These so-called “exit tax” regimes usually measure the amount of unrealized gains on a notional basis that approximates income that would have been derived had the assets been sold in the marketplace. The rationale for such taxation on unrealized gains is that a country would otherwise forgo its taxing rights with respect to the appreciation in value that occurred in this country: the allocation provision on gains in Art. 13 of the OECD Income and Capital MC gives exclusive taxing rights to the residence state.<sup>619</sup>

It is debatable whether the introduction of “exit taxes” constitutes a treaty override. The main argument advanced in favour of such taxes as permissible under tax treaties is that at the time of imposition, i.e. the transfer of residence, the taxpayer is a resident of the country levying such a tax rather than the other contracting state, meaning that no conflict can arise under the treaty. Moreover, an argument can be made that tax treaties tie in with an actual event of alienation, which does not include “deemed dispositions”. Another argument is that the application of tax treaties is triggered only where double taxation may arise as to the same income and the same taxable period. However, such a narrow view of the concept of double taxation could be attacked with a view to the object and purpose of treaty obligations as per the fundamental principle of *pacta sunt servanda* laid down in Arts. 26 and 27 of the VCLT.<sup>620</sup>

It should be noted, however, that exit taxes do not necessarily invoke problems of double taxation. An interesting example presented itself in a case involving the income tax treaty between Sweden and Austria. In that particular case the lack of exit taxation led to “double non-taxation” in that it created the opportunity for an alienation of participations in Swedish companies free of tax where sales contracts were signed after a transfer of residence from Sweden to Austria.<sup>621</sup>

The compliance of domestic “exit tax” legislation with supranational rules such as EC law providing for non-discrimination and the free movement of capital has been called into question; both the European Commission<sup>622</sup> and the European Court of Justice<sup>623</sup> have taken a firm stand against “exit taxation”. A growing number of member countries have ruled exit taxes levied under their domestic tax laws incompatible with the EC Treaty.

A recent example is Sweden. On 24 April 2008, the Swedish Supreme Administrative Court held exit taxes levied under Swedish domestic law on the transfer of residence of a Swedish company from

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<sup>618</sup> For an in-depth discussion of similarities and differences of such provisions in Austria, Denmark, France, Germany, the Netherlands, New Zealand and the United States, see Luc de Broe, “General Report”, in IFA, *Cahiers de droit fiscal international* Vol. 87b, “The Tax Treatment of Transfer of Residence of Individuals” (2002) 19. See also International Chamber of Commerce, *Exit taxes: Serious Obstacles for International Business Restructurings and Movements of Capital*, Policy Statement Prepared by the Commission on Taxation, Document 180-488 Final, Paris, 16 June 2006.

<sup>619</sup> Tax treaties will sometimes provide that the former residence state retains taxing rights for a certain period of time; an example is the tax treaty between the Netherlands and Belgium, which grants the Netherlands taxing rights with respect to certain shareholdings during a 5-year period following the emigration of the shareholder to Belgium.

<sup>620</sup> See further De Broe, “General Report” p. 66.

<sup>621</sup> For more on this case see Helmut Loukota and Wolfgang Nolz, “Das Ende der schwedischen Steuerflucht nach Österreich”, *SWI* (2006) 397 (389): “Although ... the tax treaty with Sweden has allocated the entire taxing right to Austria ..., only capital gains generated in the period of Austrian residence are taxable under the Austrian ‘exit-tax-concept’, this being so in the case of emigration but also in the case of immigration. Consequently, Sweden was prevented from taxing the capital gains because of the tax treaty, whereas Austria did not tax the capital gains because of its domestic law. Such an opportunity to escape capital gains taxation has now been terminated through a revising protocol providing for a taxation right to the (former) residence country with regard to the capital gains generated prior to the transfer of residence.”

<sup>622</sup> OECD, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *Exit taxation and the need for co-ordination of Member States’ tax policies*, COM(2006) 825 Final, Brussels, 19 December 2006.

<sup>623</sup> In *Hughes de Lasteyrie du Saillant*, Case C-9/02, decision of 11 March 2004, European Court Reports 2004 Page I-02409, the ECJ held that the French “exit tax” regime was in violation of the principle of freedom of establishment as laid down in Art. 52 of the EC Treaty (now, after amendment, Art. 43). For a topical analysis of the EC fundamental freedoms in the context of tax treaties, see Georg W. Kofler and Ruth Mason, “Double Taxation: A European ‘Switch in Time’?”, 14 *Columbia Journal of European Law* 1 (2007). For an account of various EC Member States, see Cécile Brokelind (ed) *Towards a Homogeneous EC Direct Tax Law – An assessment of the Member States’ responses to the ECJ’s case law* (2007).



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Sweden to Malta incompatible with EC law.<sup>624</sup> The company was a Malta resident under the tax treaty between Malta and Sweden and did not have a PE in Sweden since all its assets were located in the United Kingdom. The court held that the exit taxation on the assets in the form of deemed capital gains hindered the company's exercise of freedom of establishment under Art. 43 of the EC Treaty. The court's verdict was that immediate exit taxation would be disproportionate and that taxes should be levied only upon actual disposition of assets. This conclusion was drawn irrespective of whether such taxation is permitted under domestic tax rules or under a tax treaty. Disproportionality of the Swedish rules was found in that the Sweden–Malta tax treaty does not prevent Sweden's right to tax profits that arose prior to the transfer of residency.

The fact that the former residence state has already taxed part of the gain does not oblige the new residence state to take account of such taxes by limiting its taxation right to the value accrued in its country or by granting a tax credit for the taxes paid in the former state. Tax treaties do not contain any such obligations and do not explicitly address "exit taxes".<sup>625</sup> The prevailing view in academic literature is that the fictitious realization event cannot come under the allocation provision dealing with gain from the alienation of property (Art. 13), as the notion of "gain" in the context of this article is believed to presuppose an actual change in the taxpayer's wealth; consequently, the "Other Income" provision in Art. 21 is commonly seen to be applicable.<sup>626</sup>

One might also consider a subsumption under the article dealing with taxes on capital (Art. 22 of the OECD Model; the US Model does not contain a corresponding provision); this argument is weak, however, in that "exit taxes" are levied not on capital itself, but rather on an (albeit deemed) increase in value. As tax treaties do not prevent the new residence state from taxing also the portion of appreciation that occurred in the former residence state, double taxation with respect to this portion can only be avoided if a country provides for unilateral relief.

Failure to do so might well be seen as a violation of the principles of international law, but no deterring sanctions are in place either at the international level or at the EC level. In the European context, a strong policy argument can be made for the enactment of a Regulation dealing with this issue.

#### **1.3.4. Treatment of domestic income fictions under tax treaties**

In a last step, "income fictions" of the types introduced above will be revisited and examined in the tax treaty context to substantiate the position taken that an application of the specified allocation provisions will regularly lead to workable results.

In the case of a non-resident alien owning property in a country that levies taxes on imputed rental income from owner-occupied housing, the classification of such income as being "derived" in the sense of the allocation provision dealing with income from rental property (Art. 6 in the US and OECD Models) will attribute exclusive taxing rights to the country where the property is located, which is the country using the "fictional" tax base. Conversely, if one were to argue that there is no actual benefit "derived", the position could be taken that there is nevertheless an "item of income" within the meaning of the broad clause of the "Other Income" provision (Art. 21). An application of the latter provision, however, would result in exclusive taxing rights on the part of the taxpayer's state of residence. This result will likely be unsustainable in most bilateral tax treaty negotiations, as the

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<sup>624</sup> Swedish Supreme Administrative Court, Case No. 6639-06, decision of 24 April 2008.

<sup>625</sup> For a recent analysis of the topic from the perspective of "exit tax" legislation enacted in Austria see Florian Brugger, "Wegzugsbesteuerung und Abkommensrecht – Exit Taxation and Tax Treaty Law", 11 SWI (2007) 510.

<sup>626</sup> See the basic argument earlier, note 61; see also Gerald Toifl, "National Report Austria", in IFA, *Cahiers de droit fiscal international* Vol. 87b (2002) 149 (169). This approach has also been adopted by Advocate-General Juliane Kokott of the ECJ in *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, Case C-470/04, decision of 7 September 2006, European Court Reports 2006 Page I-7409; in this case the ECJ ruled that the Dutch tax on the deemed alienation of shares (including the possibility to defer the payment) violated the freedom of establishment.

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value of any actual advantages derived from the property has largely been created where such property is situated. This is an example of a case where the object and purpose of the treaty is best served if the notion “derived” is seen to encompass situations where income is deemed to have been derived by the taxpayer.

An interesting case with respect to deemed payments under CFC provisions arose before the UK Court of Appeal; at issue was whether the CFC provisions existing in UK tax law are covered under the Netherlands–United Kingdom income tax treaty.<sup>627</sup> The taxpayer was a company that was resident in the United Kingdom under domestic law and had a wholly owned subsidiary in the Netherlands. Due to loans made by the Dutch subsidiary to the UK parent company, interest was received which was free from withholding tax under Art. 11 of the tax treaty. However, since the Dutch company was a CFC for UK tax purposes, the UK parent was taxable on an apportionment of the Dutch company’s profits under UK domestic law. The taxpayer company took the position that the United Kingdom was prohibited under the treaty from imposing taxes on the deemed interest payments. The main issue was whether the amount deemed derived by the UK company was “income arising in one of the states which is beneficially owned by a resident of another” within the Interest Article of the treaty.

The Court of Appeal held that

the profits attributed to the taxpayer under UK law have lost their character as the type of profits which would qualify for exemption under the Convention – the actual foreign profits, which might have been exempt from UK tax, simply provide the measure of the notional sum which is apportioned to the taxpayer and on which UK tax is charged.

The court thus held in favour of the Commissioners, who had stated that

the ‘chargeable profits’ ... are a purely notional sum. They do not represent any profits ... nor do they represent any actual payments or receipts..., whether of interest or anything else. [They] exist only as a measure of imputation. What is apportioned to the taxpayer and subjected to tax is not ... actual profits but a notional sum which is the product of an artificial calculation.<sup>628</sup>

It is debated among scholars whether “fictitious” distributions under CFC provisions are within the scope of the Dividend, Interest and Royalty Articles of income tax treaties.<sup>629</sup> Only a few tax treaties expressly mention domestic CFC regimes in the treaty text or in protocols.<sup>630</sup> The OECD Model Commentary notes that domestic CFC regimes may in principle be applied in tax treaty situations with respect to companies subject to very low tax burdens even though no reference is made in the treaty to the CFC regime.<sup>631</sup>

Therefore, in keeping with what has been laid out so far, in situations where a CFC regime provides for a deemed dividend distribution, the “Dividends” article of tax treaties may require the shareholder’s state of residence to exempt such CFC income. As insinuated in the OECD Model Commentary, the term “paid” should be understood in a broad sense. Some guidance to this effect may also be taken from the prevailing view that the concept of “dividends paid” in Art. 5 of the EC Parent-Subsidiary Directive<sup>632</sup> includes payments classified as a distribution of profits under the laws

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<sup>627</sup> *Bricom Holdings Ltd v. IRC*, decision of 25 July 1997, STC (UK Court Reporter) 1179. The Netherlands–UK treaty was concluded in 1980 and amended in 1989, but no comments were included with respect to the treatment of the CFC legislation that had been introduced into UK income tax law in 1984.

<sup>628</sup> Cited in the appeal as STC (SCD) 228 (1996).

<sup>629</sup> For a comprehensive analysis see Michael Lang et al. (eds) *CFC Legislation, Tax Treaties and EC Law*, Kluwer Law International (2002).

<sup>630</sup> Protocols or Notes of Exchange to tax treaties concluded by the United States frequently clarify that “Under U.S. law (Section 902 of the Internal Revenue Code), when a U.S. parent receives dividends from its Controlled Foreign Corporation (CFC), the taxes paid to the foreign government by the CFC are ‘deemed-paid’ by the U.S. parent. These deemed-paid taxes are added to the direct foreign withholding taxes paid for purposes of calculating the foreign tax credit.” (Memorandum of Understanding of 31 May 1996 on the Convention between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed on May 31, 1996).

<sup>631</sup> See m.no. 23 of the Commentary to Art. 1 of the 2003 OECD Model Income Tax Convention.

<sup>632</sup> Council Directive 90/435/EEC of 23 July 1990 on the Common System of Taxation applicable in the case of Parent companies and Subsidiaries of different Member States, Official Journal L 225, 20/08/1990, 0006 – 0009.

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of the state of source, whether they be actual or deemed.<sup>633</sup> Moreover, especially in the case of dividends, it becomes obvious that payments are mostly a taxable rather than an economic event.<sup>634</sup> A comparative look at the tax treatment of dividends in different countries brings forth a common characteristic in that payments do not qualify as dividends when deductible to the payor.

Another aspect to be considered in this context as regards tax treaties concluded between EC Member States is the fact that under ECJ jurisprudence, payments whose imposition violates the fundamental freedoms cannot be considered “taxes” within the meaning of tax treaties concluded between EC Member States.<sup>635</sup>

A final point to be made is that the treatment of “fictitious income” under tax treaties hinges upon the functioning of the treaty as a “closed system” applying to “taxes on income”. The income allocation provisions are firmly intertwined with the provision on substantive scope as laid out in the article as well as with the provision on the effective method to prevent double taxation (Art. 23). However, there are no ultimate solutions as to where “fictitious income” stands in the international context; nor can there be a lasting and universal concept of “income” for purposes of tax treaty application.

Changes in a country’s treaty practice are not uncommon. For many years after the inception of the Austrian “minimum corporate income tax” described earlier, the Austrian tax authorities had taken a position that was favourable to taxpayers; foreign taxes paid were considered to be creditable against the minimum corporate income tax under Art. 23, which provides relief from double taxation regarding “taxes on income”.<sup>636</sup> Two decisions of the Austrian Fiscal Tribunal have brought about a radical change in treaty practice. The tribunal held a credit under Austrian tax treaties to be without legal cause on the grounds that the minimum corporate income tax is not a “tax on income” within the meaning of tax treaties, as it is in fact levied independently of any actual corporate income.<sup>637</sup> The Austrian tax authorities followed suit and have since disallowed a credit for this tax.<sup>638</sup>

Information exchange under Art. 2(4) may serve as a last resort to resolve international double taxation where domestic “income fictions” are introduced. Mutual notification of major changes in domestic legislation, however, will only resolve the problem where the treaty is successfully renegotiated as between the parties in this respect. Often, the start of negotiation processes will result in a “deadlock”, impairing progress on the issue at hand and might also perturb existing compromise.

### 1.3.5. Conclusions

The concept of income in international tax law hinges upon the concept of income as a tax base in each respective country. However, the concept of income in tax treaties cannot be equated with domestic concepts.<sup>639</sup> The primary purpose of income taxes under domestic law is to derive revenue, while bilateral tax treaties aim at preventing double tax burdens on the same income. Moreover, the key question to be asked when applying income tax treaties is not whether there is any “actual” economic gain; tax treaties tie in with taxable events as defined under domestic tax laws. Where a taxable event with respect to “income” gives rise to possible double tax burdens, the application of the

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<sup>633</sup> See Helminen, “Is There a Future for CFC regimes in the EU?”, 33 *Intertax* 2005, 117; Cécile Brokelind, “Ten Years of Application of the Parent-Subsidiary Directive”, *EC Tax Review* (2003) 161.

<sup>634</sup> Charles E. Kingson, “The Deep Structure of Taxation: Dividend Distributions”, 7 *The Yale Law Journal* 85 (1976) 861 (864).

<sup>635</sup> In *Cadbury Schweppes plc. v. Commissioners of Inland Revenue*, Case C-196/04, decision of 12 September 2006, European Court Reports 2006 Page I-07995, the ECJ held the UK CFC regime to be in violation of the freedom of establishment unless it can be shown that the CFC structure is “wholly artificial”. Given the fact that the Irish subsidiary concerned conducted virtually no activity, CFC rules in EC Member States might be on the decline. See further Philip Simpson, “The ECJ sets strict test for CFC legislation”, 6 *British Tax Review* (2006) 677; Clemens Philipp Schindler, “What Cadbury Schweppes reveals about legal presumptions and economic substance”, *Tax Notes International* 29 June 2006.

<sup>636</sup> See e.g. the statement of the Austrian Federal Ministry of Finance, EAS No. 1981 of 16 January 2002.

<sup>637</sup> Austrian Fiscal Tribunal (UFS) decision of 29 June 2004, RV/0158-L/04; decision of 25 January 2005, RV/0256-G/04.

<sup>638</sup> Austrian Federal Ministry of Finance, EAS No. 2652 of 30 August 2005.

<sup>639</sup> Differing Schaumburg, *Internationales Steuerrecht* Vol. 2 (1997) at 15.3., stating that the concept of income in tax treaties is to be based on the respective domestic concepts.

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specific income allocation provisions will lead to workable results that are in line with the object and purpose of tax treaties to prevent double taxation and tax evasion. Income tax treaties thus apply irrespective of whether the taxable event is triggered by a domestic “income fiction”.

Not only is a clear-cut distinction between “real” and “fictitious” income virtually impossible but it is also generally unnecessary at both domestic and international levels. A tax treaty requires “more than a mere exchange of paper in order for treaty protection to apply”.<sup>640</sup> Whereas the allocation provisions of the US and OECD Models use words like “paid” and “derived”, too literal a reading would fall short of the objective of tax treaties. Income that is deemed to be paid or derived under domestic tax laws can thus in principle come within the specific income allocation provisions of tax treaties.

Nevertheless, tax treaties do not prevent double burdens in situations where one country taxes “fictitious” income, but a subsequent change in circumstances concerning that same taxable base leaves the other state with taxing rights under the treaty that are exercised upon actual realization. Such “economic double taxation” can only be prevented by way of unilateral action. There are, however, no adequate measures available at the international level to ensure that a country will take such action. However, the context of the treaty and its effective application require that there be a basic common consensus on the concept of income that provides a foundation vital to treaty negotiations. The following considerations therefore call into focus basic conceptual foundations that may be determinative in treaty application.

## **2. Delimitation between taxes on income and taxes on capital**

“We find, in the statutes, very different attempts to define income. Rather do they assume the meaning of that term ... to be self-evident. Consequently the meaning of the statutes themselves is always vague and varying. The growing precision and progress toward a truer concept consists chiefly in the gradual disentangling of income from capital.”<sup>641</sup>

The preceding chapter has shown that the domestic notion of income as a dynamic concept that is subject to social and legislative change is a fundamental precept of treaty application in practice. Conceptual purity is not attainable in this context. Income taxes are regularly imposed on “fictitious” gains and non-existing benefits; the resulting burdens are very real, however.

While most treaties presently in force, in keeping with the OECD, US, and Nordic Conventions, apply to “taxes on income and on capital”, some treaties merely apply to “taxes on income”. Direct taxation on capital in the form of wealth taxes has come under heavy criticism in numerous countries. Critics argue that taxes on personal wealth cannot be justified where the personal income tax is based on a comprehensive notion of income as per because under a notion of income from capital based on Schanz/Haig/Simons, wealth is the result of income that has been taxed already. Seen from that perspective, the combination of individual income taxation and wealth taxation leads to juridical and economic double taxation.<sup>642</sup>

Among the writers taking the position that an income tax on savings is double taxation was Prof. Luigi Einaudi, member of the League of Nations group of Technical Experts that drafted the first international Model Tax Convention. Interestingly, Sir Josiah Stamp, second of the three Technical Experts, strongly opposed this view.<sup>643</sup>

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<sup>640</sup> See US Tax Court, *Aiken Industries, Inc. v. Commissioner of Internal Revenue*, 56 TC 925, decision of 5 August 1971.

<sup>641</sup> Irving Fisher, “Are Savings Income?”, *American Economic Association Quarterly*, 3rd Series, Vol. 9 (1908) 21. Fisher’s classic deliberations on the economic foundations of income, still relevant today, are beyond the scope of this study.

<sup>642</sup> See this argument made by Sacchetto/Castaldi, EATLP Congress Cologne 12-14 June 2003, Congress papers p. 164.

<sup>643</sup> See for further references regarding these positions *The Economic Journal* - Quarterly journal of the Royal Economic Society, Macmillan (1914) 60. This view was also endorsed by economists Arthur C. Pigou, John Stuart Mill and Jeremy Bentham.

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In principle, such economic double taxation under domestic law carries over into tax treaty application: tax treaties fundamentally tie in with domestic tax burdens as per the treaty's system of distributive articles and the classifications therein. From the tax treaty perspective, fairness considerations, e.g. as to whether a capital tax is justified under a comprehensive concept of income, are moot.

The conceptual difficulties of distinguishing between income and capital have been a "classic" topic in economic theory.<sup>644</sup> Where a country levies taxes on capital, they typically tie in with any kind of economic ownership interest, the decisive factor being the taxpayer's power to control the capital asset. The term "capital", however, is not defined in the Model conventions; neither is it defined in actual bilateral treaties. The OECD *Glossary of Statistical Terms* defines capital taxes as "levies on the values of the assets or net worth levied at irregular, and very infrequent, intervals of time." Regularity in fact is taken to be a common characteristic of the imposition of income taxes.

An example from recent treaty practice shows the difficulties in distinguishing between taxes on income and taxes on capital. Under the 2006 tax treaty between Mexico and Canada that replaced the earlier treaty signed in 1991, the Mexican "asset tax" (IMPAC) is no longer covered by the treaty. Art. 2 of the 1991 treaty, however, made reference merely to "income taxes", stating that:

1. This Convention applies to income taxes imposed by each of the Contracting States.
2. There shall be regarded as taxes on income all taxes imposed on total income or any part of income, including tax on gains derived from the alienation of movable or immovable property.
3. The existing taxes to which this Convention shall apply are:
  - (a) in Mexico: -- the income tax imposed by the Income Tax Law.

The tax as covered under the old treaty was calculated by computing the Mexican company's net assets and multiplying that base amount by 1.8%. The IMPAC had been created in 1989 as a minimum tax based on assets held, which supplements the federal income tax. In essence, the tax was levied only on taxpayers who do not generate income tax. It was therefore classified as an income tax under Mexican domestic law as well as for treaty purposes. This changed effective January 2007, when the IMPAC was changed so as to apply to the net assets of the corporation with no possibility of reducing the tax base for the company's liabilities, which effectively eliminated any link to the income tax.<sup>645</sup>

Another example of types of taxes that do not clearly fall under either category are "minimum corporate income taxes", analysed in the context of "fictitious income" above. Where the tax on "fictitious income" is determined on the basis of the corporation's assets, it is unclear whether, for tax treaty purposes, it is a tax on income or rather a tax on capital.<sup>646</sup> Where an "income fiction" existed under a treaty partner's domestic income tax system at the time the treaty was concluded, it is presumptively acknowledged and accepted by the other contracting party and thus covered by a treaty that makes reference to that country's "income tax". After conclusion of the treaty, however, in order to come within its substantive scope the tax must be "substantially similar", i.e. similar in substance to the already covered taxes. Where there were no "income fictions" in either treaty partner's domestic tax system at the time of conclusion, the newly imposed "tax on income" that is levied based on the value of a corporation's assets might be classified as a tax on capital and thus covered.

Aside from the fact that income and capital are often hard to delineate, from the earliest tax treaties onwards there has been awareness of the fact that the basis of taxes will often be a combination of income and capital elements.

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<sup>644</sup> John Hicks, *Value and Capital – An Inquiry into some Fundamental Principles of Economic Theory*, Oxford University Press, 2nd edn. (1946).

<sup>645</sup> See further Roberto del Toro/Diana González, "Mexico: Important changes made to the Asset Tax Law", *International Tax Review* February 2007.

<sup>646</sup> See Lang, "'Taxes Covered' - What is a 'Tax' according to Art. 2 OECD Model Convention?", *Bulletin for International Fiscal Documentation* 2005, 216 (219).

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An example of a combination of income and capital elements of the tax base are business franchise taxes levied on corporations for the right to be chartered or do business in certain areas; such taxes are sometimes based on a combination of income as well as assets or capital stock of a company.

In a case before the US tax authorities, the application of the discrimination article (Art. 24) to the tax liability of a French corporation under US provisions governing the Texas franchise (margin) tax was at issue.<sup>647</sup> While US taxes levied at the state rather than the federal level are outside the scope of tax treaties under Art. 2,<sup>648</sup> Art. 24 applies to “taxes of every kind and description”, including taxes levied at the state level. The French corporation claimed to be exempt from the Texas franchise tax pursuant to Art. 1(4) of the France–US Income Tax Treaty. The case was settled in favour of the argument made by the US tax authorities that the treaty as such is an income tax treaty and therefore does not apply to the Texas franchise tax due to the capital component of the tax base.<sup>649</sup> However, the character of the tax has been disputed, albeit only in the US domestic context of the constitutionality of its legislative origins. The Texas State Comptroller has publicly argued that the fact that the margin tax allows deductions makes it an income tax.<sup>650</sup> The deductibility of regular expenses is certainly a strong indication of taxation on income; this criterion can be helpful also in determining the character of a tax for purposes of income tax treaty application.

## 2.1. “Personal” and “impersonal” taxes

The English common law view of capital as a *res*, a thing, has been a universal fundament of legal and economic income theories.<sup>651</sup> Wealth taxes in the sense of taxes on the value of assets as well as property taxes are prime examples for taxes that will regularly be covered under income and capital tax treaties as “taxes on capital”.

While taxes on income are typically imposed on periodic accruals to a taxpayer’s wealth, taxes on capital are levied on the capital itself. This basic distinction appears to be the rationale for the different distributive rules governing the allocation of taxing rights for taxes on income on the one hand and taxes on capital on the other; it was the basis of the consensus reached by the drafters of the Model tax treaty as to the appropriate division of the income tax base among nations. Taxes on income are dealt with in Arts. 6 through 21 of the OECD Model, whereas taxes on capital are dealt with in Art. 22. Arts. 6 through 21 favour source taxation, a tendency that present-day nations have been moving away from, especially with respect to income from capital assets.<sup>652</sup>

Seligman was one of the Technical Experts whose Report laid the foundation for the basic framework used to this day in international tax treaty negotiations. In one of his treatises he lays out the essence of a distinction between income, capital, and capital gains: “Mere advance in value in no sense constitutes ... gains, profits, or income.... It constitutes and can be treated merely as increase of capital.”<sup>653</sup> When applied to tax treaties that refer to income, capital and capital gains, this distinction is a useful conceptual starting point.

The 1923 Report submitted by the Technical Experts made a basic distinction between “taxes on global income” and “other taxes”. In 1925, based on the feedback of the representatives of various nations, the Technical Experts presented a report incorporating a “compromise” that was endorsed by

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<sup>647</sup> Texas State Comptroller, Notice number 9312L1276G04 of November 12, 1993.

<sup>648</sup> Article 2(3(b)) of the 2006 US Model Income Tax Convention specifies “Federal” taxes only.

<sup>649</sup> The earned surplus component of the franchise tax was seen to be too marginal to present an issue.

<sup>650</sup> See press release dated April 21, 2006, in which Texas Comptroller Carole Keeton Strayhorn requested that the Attorney General issue a formal opinion addressing the constitutionality of the tax; available at: [www.window.state.tx.us/news/60421statement.html](http://www.window.state.tx.us/news/60421statement.html) (last accessed May 2010).

<sup>651</sup> G. C. Harcourt/N. F. Laing (eds.) *Capital and Growth* (1973) 9.

<sup>652</sup> See further William B. Barker, “Optimal International Taxation and Tax Competition: Overcoming the Contradictions”, 22 *Northwestern Journal of International Law and Business* (2002) 161.

<sup>653</sup> *Principles of Economics* (1926) 66.

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the ICC. This compromise appropriated the 1923 distinction between taxes on global income and other taxes, but made the general distinction one between “personal” and “impersonal” taxes.<sup>654</sup>

In 1925, seven experts were appointed (nationals of Belgium, France, the United Kingdom, Italy, the Netherlands, Switzerland and the then Czechoslovakia). The experts observed that taxes based on origin were very common particularly in the form of impersonal taxes, and were “impressed by the advance made by the concept of personal taxation based on residence.... To avoid difficulties, the experts decided not to propose a single solution applicable to all classes of taxes whatsoever.”

For “impersonal or schedular taxes” they accepted the primary taxing right of the source state, i.e. a concept of origin, while with respect to personal taxes, the experts sought to assert primary taxing rights for the state of permanent residence (“fiscal domicile”) of the taxpayer. The “personal or general income tax” was described as “a tax (which may be at a progressive rate) charged upon the whole income of a taxpayer, from whatever source derived.”

By 1927, the Committee of Technical Experts was expanded to include members from Germany, Poland, Japan, Venezuela, Argentina and the United States. The Commentary to the 1927 Draft Convention states:

After stating the general purpose of the Convention, Article 1 defines its scope: it governs direct impersonal or personal taxes. Desirous of avoiding any controversy on matters of doctrine, the experts have not defined the two great categories of direct taxes.... The Contracting States will themselves decide which of their direct taxes they regard, for the purposes of the Convention, as being impersonal or personal taxes.

The 1927 League of Nations Draft Convention contained distributive rules under the heading of “impersonal taxes” for “income from immovable property, i.e., that which corresponds to the actual or presumed rental value of such property, as well as any other income from such property...”,<sup>655</sup> thus notably explicitly including income taxes on the basis of imputed rental value.<sup>656</sup>

Also included under the heading of impersonal taxes were: “Income from public funds, bonds, including mortgage bonds, loans and deposits or current accounts...”<sup>657</sup> and “Income from shares or similar interests.” Mentioned under the heading of “personal taxes” is “the personal tax on the total income” (Art. 10). The distributive rule in Art. 10 provides that personal taxes shall be levied by the state in which the taxpayer has his fiscal domicile and provides for deductions from the personal tax if the state of domicile does not impose impersonal taxes. The Commentary to the Report stated: “This Convention applies to direct taxes, whether impersonal or personal. The Contracting States are required to state which of their taxes they regard as impersonal and which as personal.”<sup>658</sup>

The final article, preceding a provision on mutual agreement between the treaty partners, points out: “The principles laid down in the preceding articles shall be applicable *mutatis mutandis*, to the recurrent taxes on total wealth, capital, or increments of total wealth, according as these taxes are impersonal or personal.”<sup>659</sup>

The express reference to “recurrent” taxes apparently aims to delineate taxes on income and capital from taxes on estates, inheritances and gifts, the latter being “one-time” type events rather than recurring impositions. The distinction between personal and impersonal taxes was later abandoned, since for nations with “unified” tax systems rather than schedular systems, the personal/impersonal distinction raised a spectre of uncertainty in the treaty. Broad language was chosen (“taxes on income

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<sup>654</sup> See Annex I for the texts of the 1927 and 1928 drafts, Art. 1 respectively.

<sup>655</sup> Geneva, April 1927 League of Nations Double Taxation and Tax Evasion Report, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Draft of a Bilateral Convention for the Prevention of Double Taxation, Art. 2.

<sup>656</sup> Cf. the above discussion of “fictitious income” in tax treaties and the case of owner-occupied housing.

<sup>657</sup> 1927 Draft of a Bilateral Convention for the Prevention of Double Taxation, Art. 3.

<sup>658</sup> Report submitted by the Committee of Technical Experts on double taxation and tax evasion at London on 12 April 1927, League of Nations C.216, M.85, 1927, II, Draft of a bilateral Convention for the prevention of double taxation, Comments on §§ 1 and 2.

<sup>659</sup> *Id.*, Art.12.

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and on capital”) and categorizations avoided to retain an autonomous understanding of the Model texts.

The separate distributive rule (Art. 22) dealing with capital arose from early treaties which provided that certain provisions relating to income should also apply to capital taxes. The London Draft similarly provided that the provisions relating to income taxes should also apply to taxes on property, capital or increments of wealth. The OEEC’s Second Report of 1959, however, pointed out that this approach needed refinement and specified the treatment for immovable property, permanent establishments, and shipping and aircraft.<sup>660</sup>

The OECD and US Model Conventions have adopted conforming rules, with the exception that the US Model replaced the term “immovable property” used in the OECD Model with the term “real property”. Art. 22(2) deals with movable business and non-business property, including “incorporeal” property such as goodwill and includes debts, thus in balance signifying net property.<sup>661</sup> Neither “capital” nor “immovable property” and “movable property” are defined in the Model texts. The distinction between business property and non-business property provided in the Model should be seen to be autonomous from domestic concepts for purposes of applying the treaty’s allocation provisions, as the domestic law of the contracting state applying the treaty may not know such distinction, or conceptual distinctions may differ as between the parties. Para. 3 deals with capital, i.e. movable and immovable property, pertaining to the operation of ships or aircraft. Para. 4 is a catch-all provision dealing with “all other elements of capital” not covered in paras. 1 through 3.

The Model Commentary clarifies that Art. 22 applies only to taxes on capital within the meaning of Art. 2 MC. However, similar to the concept of income, academic debates over the concept of capital have not yielded clear results. The system of the Model treaty seems to see capital as property controlling gain over time. The term refers to any kind of ownership interest in such property. Mere controlling power is sufficient if such is the basis underlying domestic tax burdens on property. The Model Commentary refers to mutual agreement among the contracting parties in cases of double taxation and “double non-taxation” as a result of differences in domestic provisions where the holder of legal title to capital and its beneficial owner are residents of different countries.

## 2.2. Capital gains taxes

Capital taxes in the sense of Arts. 2 and 22 are such taxes that are levied on the capital itself, the most common example being wealth taxes. Capital gains taxes, on the other hand, are not levied on capital as such, but on gains derived from property. The universal idea behind capital gains taxation is that such incomings should be a taxable event to the same event as “regular” income. Capital gains taxes are essentially taxes on income flows rather than capital and are therefore included in the income tax base in many countries. It should be noted, however, that capital gains taxes have been seen as an alternative to capital taxes since, like the latter, they have been introduced to secure yields from the personal income tax yield and to improve horizontal and vertical equity.<sup>662</sup> When Australia and Canada introduced capital gains taxes during the 1970s, it was made clear that the introduction of a capital gains tax (including capital gains tax on death in Canada) was sufficient justification to abolish taxes on bequests and refrain from imposing net wealth taxes.<sup>663</sup>

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<sup>660</sup> Avery Jones et al. (eds.) “The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States”, *Bulletin for International Taxation* June 2006, 220 (225).

<sup>661</sup> Vogel, Commentary to Art. 22 (2), m.no. 21.

<sup>662</sup> F. A. Hayek, *The Constitution of Liberty* (1960) 31.

<sup>663</sup> See further Herbert G. Grubel, “The case for the Elimination of Capital Gains Taxes in Canada”, as well as John Freebairn, “Indexation and Australian Capital Gains Taxation”, in Herbert G. Grubel (ed.) *International Evidence on the Effects of Having No Capital Gains Taxes*, pp. 3 and 123, resp.



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Due to the fact that capital gains taxation differs vastly from one country to another, both the OECD and the US Models contain a separate provision (Art. 13) dealing with such gains. The OECD Model Commentary notes:

The Article does not specify to what kind of tax it applies. It is understood that the Article must apply to all kinds of taxes levied by a Contracting State on capital gains. The wording of Article 2 is large enough to achieve this aim and also to include special taxes on capital gains.<sup>664</sup>

Capital gains are considered income in some countries (e.g. the United Kingdom) while in others, they are classified as profits rather than regular income (an example is Japan). Due to different approaches in domestic tax systems, the concept of capital gains in tax treaties is ambiguous in many respects. Seligman took the position that capital gains are income as soon as they are realized in the sense that the taxpayer has economic value at his/her disposal.<sup>665</sup>

A recent decision of the High Court of Australia dealt with the long-standing issue of how to treat capital gains under treaties concluded before the introduction of a separate capital gains tax as part of the Australian income tax. In a decision of 10 October 2008,<sup>666</sup> the Court affirmed that the Australia–Switzerland tax treaty protects Swiss residents from the imposition of Australian capital gains tax. The case involved a Swiss resident holding company that reported capital gains on the disposal of shares in an Australian subsidiary during the 2004 tax year. The applicable treaty was concluded at a time when Australia did not have a separate capital gains tax. Tax treaties concluded by Australia before and after the introduction of the capital gains tax defined the “taxes covered” to be the Australian income tax. In its assessment of tax, the competent tax authority (the Australian Taxation Office (ATO)), included the net capital gain in the assessable income of the company, as the tax is construed to include the gain as assessable income.

Art. 2 of the Australia–Switzerland treaty did not contain a general description analogous to Art. 2(1) and (2) of the OECD Model texts. Rather, Art. 2(1) of the treaty listed “the Australian income tax” as part of the existing taxes to which the agreement applies and stated in para. 2 that the treaty shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of the treaty.

The Court disagreed with prior rulings<sup>667</sup> issued by the ATO as to whether treaties concluded by Australia before the inception of the Australian capital gains tax (CGT) in 1985 were applicable to this tax by way of its classification as “substantially similar” to the income tax. The ATO took the position that the CGT was not a substantially similar tax for purposes of treaties concluded before 1985; the ruling states in pertinent part:

It is the ATO’s view that there was no agreement in Australia’s pre-CGT treaties to cover capital gains (other than ‘borderline gains’) and that an application of the rules of treaty interpretation adopted internationally and by Australian courts demonstrates this. Australia did not have a comprehensive CGT regime at the time the pre-CGT treaties were negotiated and such a regime was not in contemplation. While the treaties provide a mechanism for extension of treaty coverage to taxes not in existence at the time of signature, that extension is limited to similar taxes. The ATO considers that Australia’s CGT is not a substantially similar tax. Even if this is not the case, the distributive rules of pre-CGT treaties do not limit domestic law taxing rights over capital gains.

Aside from the ATO’s main argument that Australian capital gains taxes were not substantially similar to the income tax, for some treaties the argument was made that the treaty did not contain a

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<sup>664</sup> OECD Model Commentary to Art. 13, m.no. 4.

<sup>665</sup> Plehn, “Review of *The Income Tax. A Study of the History, Theory, and Practice of Income Taxation at Home and Abroad* by Edwin R.A. Seligman, 5 *The American Economic Review*. 1, March 1915, 114 (117).

<sup>666</sup> *Virgin Holdings SA v. Commissioner of Taxation*, High Court of Australia, FCA 1503, 10 October 2008. While the decision is now largely of historical value from an Australian tax perspective following changes to the CGT law (from December 2006, Australia broadly exempts foreign residents from Australian CGT on the sale of shares in an Australian company), the case will still be of interest to foreign residents who seek treaty relief in respect of pre-December 2006 disposals.

<sup>667</sup> ATO, Draft Taxation Ruling TR 2000/D12 of 2000, followed by Taxation Ruling TR 2001/12, entitled “Income Tax and Capital Gains Tax: Capital Gains in Pre-CGT Tax Treaties”, issued 19 December 2001. See the discussion in Deutsch/Sharkey, “Australia’s Capital Gains Tax and Double Taxation Agreements”, *Bulletin for International Fiscal Documentation* 2002, pp. 228 et seq.

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distributive article on the alienation of property, which was seen to suggest that no agreement was reached by the parties to bring capital gains within treaty scope.

Justice Gzell noted in his article “Treaty Application to a Capital Gains Tax Introduced after Conclusion of the Treaty”<sup>668</sup> that many treaties concluded before introduction of the Australian capital gains tax actually did apply to capital gains, as their allocation provisions referred to “income or gains”, “income or profits” or “income from alienation”. The concept of income as envisaged by the drafters of the OECD MC is certainly broad enough to encompass capital gains, unless the specific treaty language suggests otherwise. Where the parties do not include a provision on capital gains, such a tax may still be covered where it is “substantially similar” to the income tax of either contracting party. The Court seems to confirm this approach by holding that the term “Australian income tax” in Article 2(1) of the Australia–Switzerland treaty encompassed, at the time of the conclusion of the Swiss treaty, the taxation of capital gains even though Australia did not have a CGT regime at the time, since the broad basis of Australian income tax had always encompassed gains of that kind as well.

Vogel described the issue of capital gains taxes under tax treaties as follows: “Taxation of capital gains is normally dealt with in income tax laws, though in some instances separate legislation is devoted to that subject. Consequently, any new capital gains tax will for Treaty purposes normally have to be considered as being at least similar to income taxes.”<sup>669</sup> Irrespective of whether the treaty refers to taxes on gains analogous to the general description in para. 2 of the OECD Model, and in fact even where no explicit mention is made of capital gains taxes in the list of taxes covered, such taxes will still be covered if they had been taxed as part of the income basis.

In a case that arose in Denmark,<sup>670</sup> the issue was whether a flat rate tax on capital gains introduced after the entry into force of the Denmark–France treaty of 1957 was a similar tax to the income tax (which was expressly covered by the treaty). The Danish High Court held that a flat-rate tax on the gross amount of payment on the purchase of a pension was not a substantially similar tax to income tax. The French tax authorities accepted the view of the Danish authorities published on the basis of this decision that the treaty did not apply to such a tax as it cannot be seen as a tax on gains. Capital gains taxes as per Art. 13 are such that are levied on gains or profits.

The aspect of gains is what distinguishes capital gains taxes from inheritance taxes: both inheritance taxes and capital gains taxes are levied upon the movement of capital from one person to another. However, while inheritance tax charges tax on the entire amount of capital that is transferred, capital gains tax is levied only on the gain, i.e. the difference between the value at the time of transfer and the value at the time it was last moved (e.g. its purchase). In accordance with what appears to be an internationally unanimous understanding, Art. 13 covers gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, and even the passing of property at death. Regarding these gifts and transfers at death mentioned in the context of the capital gains article, Vogel pointed out that this means gains taxable to the transferor, e.g. where untaxed reserves are freed up by the transfer. Gains to the transferee (gift and inheritance) and on the estate (estate taxes) on the other hand may be covered by separate tax treaties on gifts, estates and inheritances. Where a jurisdiction imposes capital gains taxes and inheritance taxes (e.g. the United Kingdom), death is usually exempted from the capital gains tax. Where capital gains are taxed at death, a factor in delimiting inheritance taxes from income/capital gains taxation, albeit not determinative, is whether the taxpayer is entitled to a basis step-up regarding any future transfer of the property received.

Capital duties are typically not covered by income tax treaties (cf. the above deliberations on stamp duties and taxes like the Italian IRAP). Some countries levy taxes upon contributions of capital to a

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<sup>668</sup> Justice Gzell, “Treaty Application to a Capital Gains Tax Introduced after Conclusion of the Treaty”, ALJ 76 (2002) 309.

<sup>669</sup> K. Vogel, *Double Taxation Conventions* (1998) Commentary to Art. 13, m.no. 6.

<sup>670</sup> Danish High Court of the Eastern District, Case No. 300/1998.

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corporation; these are usually outside the scope of tax treaties. An example is the “capital transfer tax” (*Kapitalverkehrssteuer*) levied on Austrian corporations where a corporation issues stock in consideration for a capital contribution, or in cases where the contribution is likely to increase the value of the contributor’s interest in the corporation. As regards Member States of the European Community, there is an EC Directive on Capital Duties (69/335/EEC) that looks to regulate capital duties.<sup>671</sup>

While capital (wealth) taxes on the value of assets as levied in many countries are typically measured by the ability-to-pay principle, which states that the amount of taxes paid should relate to the taxpayer’s income or wealth, capital transfer taxation ties in with a transfer event between individuals. Nevertheless, as estate and inheritance taxes are based on the value of the property rather than the income generated from it, conceptually they could quite well be covered by Art. 22, were it not for their explicit exclusion in para. 1 of the OECD Model Commentary to Art. 22. Drawing the borderline between these taxes is not an easy task especially where the parties qualify the same event differently. Problems at the intersection of income and capital taxes on the one hand, and gift, estate and inheritance taxes on the other hand are dealt with in more detail subsequently.

## **C. Taxes on estates, inheritances and gifts**

### **1. Context of the 1982 OECD Model Convention**

Treaties on “death duties” are among the oldest bilateral tax treaties concluded.<sup>672</sup> The 1923 League of Nations Report prepared by the Technical Experts noted with respect to estate or inheritance taxes (then referred to as “death duties”) that the country of situs should have exclusive taxing rights in the case of real estate and moveable property closely connected with real estate, but that the claim of the country of domicile was preferred regarding corporate shares, corporate bonds, and general credits. The area was pushed to the sidelines in the League of Nations’ 1925 Report, dealing with “general or personal taxes on income (to the latter may be added succession duties and taxes on capital).”<sup>673</sup>

Consecutive meetings of the OEEC and OECD’s Committee on Fiscal Affairs/Fiscal Committee led to the 1966 OECD Draft Double Taxation Convention on Estates and Inheritances, last updated and expanded in scope in 1982 to include gifts.<sup>674</sup> The Committee on Fiscal Affairs revised the 1966 Estate Tax Draft “with the aim of bringing it into line with the 1977 Income Tax Model and to improve it wherever the need arose.”<sup>675</sup> The main amendment focused on the fact that gifts among living persons (transfers *inter vivos*) are treated essentially the same way as transfers at death:

The reasons for avoiding double taxation in respect of death duties also hold true for taxes on gifts *inter vivos* since such taxes are in some respects very similar to, and are moreover closely interconnected with, death duties in many countries. The Committee on Fiscal Affairs decided therefore that the time had come to include taxes on gifts *inter vivos* within the framework of a Model Convention.<sup>676</sup>

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<sup>671</sup> For a detailed analysis see Arvind Ashta, *The EC Directive on Capital Duties (69/335/EEC)*, SSRN Research Network, January 2007.

<sup>672</sup> Examples are the 1922 Treaty between the Czechoslovak Republic and the German Reich for the Purpose of Preventing Double Taxation in respect of Death Duties (publication date: 18 March 1922; effective date: 21 April 1923); the 1926 Convention Concluded between the Republic of Austria and the Republic of Poland with a view to avoiding the double collection of Succession Duties (publication date: 24 November 1926; effective date: 6 June 1928); the 1924 Treaty Between Austria and Hungary for the Avoidance of Double Taxation in Respect of Death Duties (publication date: 8 November 1924; effective date: 10 November 1925); the 1926 Agreement between France and Luxemburg regarding reduction in Taxes and Duties granted to French and Luxemburg Nationals taxable in the Territory of the Other State (publication date: 16 January 1926).

<sup>673</sup> League of Nations, *Double Taxation and Tax Evasion (1925) Part I, Introduction*.

<sup>674</sup> Cf. Commentary on the Model Double Taxation Convention on Estates, Inheritances, and on Gifts, Introductory Report by the Committee on Fiscal Affairs, m.no. 3: “The main feature of the new Model, when compared with the former Draft, is that taxes on gifts *inter vivos* are now included within the scope of the Convention.”

<sup>675</sup> Commentary on the Model Double Taxation Convention on Estates, Inheritances, and on Gifts, Introductory Report by the Committee on Fiscal Affairs, m.no. 10. The relationship of the Estate Tax Model with the Income Tax Model is dealt with in more detail below.

<sup>676</sup> Preceding note, m.no. 11.

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The rationale of treating bequests at death and lifetime gifts alike under domestic tax laws is usually that persons distributing substantially all of their wealth before their death in order to avoid estate and inheritance taxes should not escape taxation.

The 1982 Model and Commentaries have so far not been amended or updated, presumably due to the lack of treaties in this area. Governments globally have focused more on treaty negotiations concerning income and capital, which can only in part be explained by the fact that these are areas that promote trade between the parties involved.<sup>677</sup> In fact, the likelihood of unrelieved double or multiple taxation in the area of estate, inheritance and gift taxes is considerable.

A basic example illustrates this point. A national of the Netherlands dies in Belgium, where (s)he had emigrated. Among his/her assets is a piece of real estate in France. The only heir lives in Spain. Both the Netherlands and Belgium levy inheritance taxes on the basis of residence of the decedent. Spain, on the other hand, levies inheritance taxes on the recipient where the recipient is a resident of Spain. France levies inheritance tax on real estate located in France. While there is an estate, inheritance and gift tax treaty between Belgium and France, with the result that no tax is levied in Belgium, no treaties in this area have been concluded between Belgium and Spain, Belgium and the Netherlands, or France and the Netherlands. The same economic event, i.e. the transfer of the piece of real estate to the heir, will thus be subject to tax in three countries.

The Model Commentary notes:

Although taxes on estates and inheritances and on gifts are imposed only on specific events, the burden of taxation resulting from the simultaneous levy of the taxes imposed under the domestic laws of several countries is certainly prejudicial to the development of economic relations and in particular to movements of private capital between Member countries.

Nevertheless, the number of treaties concluded in this area is very low as compared to the expansive network of income and capital tax treaties. The primary reason, it is submitted here, is that countries are apprehensive of unclear and adverse results caused by parallel application of both an income and capital and an estate, inheritance and gift tax treaty. Throughout the 19<sup>th</sup> century, bilateral tax treaties were prevalently concluded with respect to “death duties”/“succession duties”. Even countries that, at present, do not have active treaties in this area did have active treaties regarding estate and inheritance taxation in the late 19<sup>th</sup> century; examples are France and the United Kingdom.<sup>678</sup>

The rise of income taxation in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries brought about a growing number of treaties in this area as well as efforts of harmonization by the League of Nations and OEEC/OECD primarily with regard to taxes on income and capital; double taxation with respect to taxes on estates, inheritances and gifts has since been addressed only secondarily in treaty practice, as a supplement to treaty protection provided in the area of income and capital taxation. The number of treaties concluded in the area of estates, inheritances and gifts is considerably lower than the number of treaties regarding income and capital taxes.

The Model Commentary, however, stresses the fact that

[a]lthough the network of double taxation conventions applying to taxes on estates and inheritances is smaller than that covering taxes on income, the 1966 Estate Tax Draft has also had significant repercussions since Member countries have largely conformed to it when concluding or revising bilateral conventions. The importance of the work of the Fiscal Committee and now of the Committee on Fiscal Affairs should not be measured merely by the number of conventions concluded between Member countries but also by the fact that, in accordance with the Recommendations of the Council of the OECD, these conventions follow the pattern and, in most cases, the main provisions of the Model Conventions. These Model Conventions have facilitated bilateral negotiations between

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<sup>677</sup> Willem van der Berg identifies this reason in “Future of Inheritance and Gift Tax Treaties”, in M. Stefaner/M. Züger (eds.) *Tax Treaty Policy and Development* (2005) 517 (526).

<sup>678</sup> For an in-depth – now historical – perspective, see A. Boes, *Das Wesen der Doppelbesteuerung - geschichtlich und positiv-rechtlich* (1928) 28 et seq.

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Member countries and achieved a desirable harmonization in bilateral conventions for the benefit of both taxpayers and national administrations. Moreover, the Commentaries have facilitated the interpretation and application of bilateral conventions along common lines.<sup>679</sup>

Art. 2 in the 1982 Estates, Inheritances and Gifts MC is similar in structure to the Income and Capital MC: the general description in Art. 2(1) refers to “taxes on estates and inheritances and on gifts imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied”, and thus corresponds to Art. 2(1) in the Income and Capital MC.

Art. 2(2) reads:

There shall be regarded as taxes on estates and inheritances taxes imposed by reason of death in the form of taxes on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on donations mortis causa. There shall be regarded as taxes on gifts taxes imposed on transfers inter vivos only because such transfers are made for no, or less than full, consideration.

As laid out above in the analysis of the structure of Art. 2, the main functional difference between the Income and Capital Model text and the Estates, Inheritances and Gifts Model text lies in para. 3: the list of *taxes on estates, inheritances and on gifts* is exhaustive rather than demonstrative, unless the parties specify otherwise, e.g. by inserting the words “in particular”.

Where, as between two contracting parties, both a treaty modelled after the OECD’s Income and Capital MC and an Estates, Inheritances and Gifts Tax treaty were concluded, broad concepts in either treaty are likely to cause confusion and unclarity in treaty application. It seems that therein lies a key reason why so few treaties have been concluded in the area of estate, inheritance and gift taxes. However, the existence of both types of treaties suggests that no overlaps in substantive scope were intended by the contracting parties, and inferences can be drawn from the concepts in one type of treaty to the scope of application of the other.

Following an analysis of the concepts of estates, inheritances and gifts, as compared to income and capital, the study analyses the interrelation of treaties in the area of income and capital on the one hand and estates, inheritances and gifts on the other hand, and aims to develop an interpretive approach to possible overlaps in substantive scope of these two types of treaties.

## **2. Estates, inheritances and gifts**

The OECD Model text and Commentary do not give a definition of estates, inheritances or gifts. The key phrases in the description of taxes covered are: taxes imposed on *transfers* of property *by reason of death*, on the one hand, and taxes on *transfers for no, or less than full, consideration*.

The phrase “by reason of death” is very broad, but appropriately so in that it captures situations where countries add gifts that are made within a certain period of death to the value of the decedent’s assets for purposes of estate and inheritance taxes. The phrase “for no, or less than full, consideration” describing gifts indicates that transfers that are really in consideration of services provided cannot come within the scope of the Estates, Inheritances and Gifts Tax Model, but would be governed by the Income and Capital Tax Model (Art. 15, dealing with services).

The most straightforward common feature of taxes on estates, inheritances and gifts is that they are levied upon the transfer of property: the terminology employed throughout the Model refers to unilateral *transfers to heirs, legatees, donees or other beneficiaries*.

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<sup>679</sup> 1982 Commentary on the Model Double Taxation Convention on Estates and Inheritances and on Gifts, Introductory Report by the Committee on Fiscal Affairs - Implementation of the 1966 Estate Tax Draft, m.no. 7 (with reference to a table of existing treaties) and m.no. 8.

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Art. 1 of the OECD Model lays out the estates, inheritances, and gifts covered, providing that “the treaty only applies to those estates and inheritances where the deceased was domiciled in one of the states, or in the case of gifts, where the donor was so domiciled.” The treaty thus focuses on property rather than persons, namely property which forms part of the estate of, or a gift made by, the resident of a contracting state. Under the Income and Capital MC, on the other hand, the focus is on *persons* who are *residents*.

Estate, inheritance and gift taxes in various countries are levied on the basis of nationality of the deceased/donor.<sup>680</sup> Some countries use the concept of residence of the donor/deceased to determine the jurisdictional basis of inheritance and gift taxes.<sup>681</sup> Yet other countries see the residence of the recipient as the basis on which to levy inheritance or gift taxes.<sup>682</sup> Conversely, tax burdens in several countries tie into the location of immovable property transferred upon death or by way of a gift.<sup>683</sup>

Pursuant to the text of Art. 1(2) (“taxes *on the corpus of the estate*”), estate taxes are such taxes that are levied on the estate itself. This approach is taken in countries like the United States, the United Kingdom, Korea and New Zealand, and is rooted in the frequent use of testamentary trusts in these countries, where determining the value of each beneficiary’s interest may be difficult.<sup>684</sup>

While estate, inheritance and gift taxes share the features of transfer taxes, estate taxes distinguish themselves in that the estate tax is levied on the entire taxable estate, which will usually include the money used to pay the tax, while gift taxes and inheritance taxes apply only to the value that is being transferred. The estate is often treated as a legal person under domestic law and the tax is based on value transferred, with graduated rates depending on the value. The deceased’s property is thus not taxed at the beneficiary level but rather before transfer of the property is complete. Estate taxes as levied on the transferor are seen to be based upon the power to transmit in that their basis is the net value of the transferor’s estate.

Inheritance taxes tie in with the transfer event as well, but may be levied either at the transferor or at the beneficiary level. They are calculated based on the decrease in value at the transferor level, or the family or marital relationship between transferor and beneficiary and/or value received by the beneficiary.

Some countries blend elements of both estate and inheritance taxes; examples are Italy and Greece.<sup>685</sup> Furthermore, estate/inheritance and gift taxes are oftentimes interlinked in domestic tax systems.<sup>686</sup> In a number of countries that levy an inheritance tax, the gift tax is based on similar principles. In some countries, such as Belgium and Luxembourg, gift taxes are levied independently in the form of a registration tax.<sup>687</sup>

Inheritance and estate taxes are often linked to gift taxes; the respective rules are usually coordinated in order to prevent gift-giving as a method to evade estate and inheritance taxation. An example is France, where the value of any gifts given by the deceased to his/her heirs during a six-year period prior to his/her death is added to the value of the bequeathed amount.

The phrase “transfers for no, or less than full, consideration” in Art. 1 of the Estates, Inheritances and Gifts MC indicates that a gift exists where the value of the property transferred exceeds any

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<sup>680</sup> Examples are the Netherlands, Sweden and Germany.

<sup>681</sup> Examples are Luxembourg and Italy.

<sup>682</sup> An example is Spain.

<sup>683</sup> This is the case in Denmark.

<sup>684</sup> Wolfe D. Goodman, “General Report”, in *International double taxation of inheritances and gifts, Cahiers de droit fiscal international* Vol. 70b, 15 (20).

<sup>686</sup> An example is the Unified Estate and Gift Tax, a federal tax imposed in the United States on the net value of the decedent’s estate and on gifts of certain amounts.

<sup>687</sup> See further F. Sonneveldt and J.W. Zwemmer, “Avoidance of multiple inheritance taxation within Europe”, General Report for the Annual Congress of the EATLP, Maastricht (2000).

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consideration to the donor. Nothing in the Model text or the Commentary indicates that the donor cannot be a legal person. The same principle should hold true in the context of estate and inheritance taxation: the direct distributor on occasion of the transferor's death need not be a natural person. Transfers can be indirect in that the decedent is free to determine the method of distribution. A will may, for example, compel heirs to transfer property to a specified legatee.

The definition of "domicile" in Art. 4 includes "place of management". It is thus made clear that gifts made by corporations, trusts, and similar entities other than individuals come within the scope of the Estates, Inheritances and Gifts Model Convention. The donee is not addressed in the Model text; however, there is nothing to suggest that the donee cannot be a legal person as well.

Provided that the taxes are imposed *by reason of death*, it is immaterial whether they are imposed on property bequeathed by the deceased or on property transferred during the transferor's lifetime where under the law of one or both of the contracting states, the property transferred is subject to estate tax at the moment of death of the transferor.<sup>688</sup> Such transfers are thus not classified as gifts under the Model treaty, as the treaty ties in with the point in time at which the tax arises.

The basic concept of tax seems to be identical in both the Income and Capital and the Estates, Inheritances and Gifts Tax Models. Therefore, stamp duties or registration or recording fees levied "by reason of death" generally do not qualify as taxes covered by the OECD Estates, Inheritances and Gifts MC. Where taxes levied "by reason of death" are levied also on other occasions, a conclusion as to their coverage under Estates, Inheritances and Gifts Tax Treaties will be less straightforward.

## **2.1. Conditional transfers, usufruct, fideicommissum**

From the phrase "heirs, legatees, *or other beneficiaries*" (emphasis added) it can be concluded that the transfer does not have to be direct. Legatees, for example, receive a legacy by way of the decedent's last will and testament, giving them merely a claim against the estate or the heirs, but no entitlement to decedent's property itself.

Art. 2(2) also mentions "*donationes mortis causa*", i.e. the transfer of property by a person who faces impending death. Such transfer only takes effect upon death, before which it may be revoked at any time. The donee thereby becomes the owner of the property subject to the condition of the owner's death and absent revocation by the owner.

Moreover, the Model Commentary includes the conditional transfer of property at death or inter vivos subject to the condition that the property, or what is left of it, has to be passed on to a new beneficiary on the occurrence of a specified event.<sup>689</sup> Therefore, the treaty concept of the treaty concept of estates, inheritances and gifts encompasses all types of conditional transfers, whether they be subject to a condition precedent or a condition subsequent.

The Commentary specifically mentions usufructs as being covered under the Model treaty and describes usufructs as a temporary division of economic and legal ownership rights that may be created by operation of law, by gift or by will. The usufruct is given the right to use property and derive profits from it, while the legal right to same property is with another person.

Also explicitly included is the creation of a fideicommissum. The fideicommissum is known in many countries as a disposition either by law, by gift or on death by which property is transferred to several persons successively, subject to the condition that a successor nominee be alive at the moment of the death of the preceding nominee. Where it is instituted by law, the successor is usually deemed to acquire the property from the creator of the fideicommissum, but for tax purposes some countries may

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<sup>688</sup> 1982 OECD Estates, Inheritances and Gifts MC Model Commentary on Art. 2, m.no. 5.

<sup>689</sup> OECD Model Commentary on Art. 2(22).

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view the property as acquired from the previous beneficiary. This again showcases the danger of unrelieved double taxation.

In the above-mentioned or similar cases involving “chains of transfer”, different countries may classify the transfer as one between the respective “middleman” and the beneficiary, which may also mean that no transfer by reason of death is recognized, as the event is seen as a gift from “middleman” to beneficiary. Given that a large number of treaties apply solely to estates and inheritances and do not include gifts, this issue needs to be considered during treaty negotiation.

## **2.2. Trusts and foundations**

In addition to conditional transfers and arrangements like usufructs and fideicommissa, the Model Commentary explicitly includes trusts and foundations, which constitute arrangements to transfer the right to enjoy the benefits of property without change in formal legal ownership.<sup>690</sup> The ways in which Member countries levy taxes regarding trusts (usually countries that adopted English “common law”) or foundations (“private law” countries) vary considerably.

Trusts and foundations typically feature a two-tier system of taxation: taxes are levied on income to the trustee on the one hand and to the beneficiaries on the other hand. Common law countries like Australia, Canada, Hong Kong, Singapore, the United Kingdom, the United States and New Zealand have adopted a concept of trust where a right of property is held by one person (the trustee) for the benefit of another person (the beneficiary); the person giving up the property is called the settlor. Trusts can be created by gift during the life of the settlor (inter vivos trusts) or by last will and testament (testamentary trusts).

The Model Commentary distinguishes between trusts where the beneficiary has an immediate right to the whole of the income and capital of the trust, trusts where an identified beneficiary or beneficiaries have a right only to the whole or part of the income or enjoyment of the property but not the capital, and trusts where the instrument does not specify the rights of the potential beneficiary or beneficiaries, and the trustee is given discretion as to whether and for whose benefit property or income is to be distributed.<sup>691</sup> Income from the assets held by the trust is usually taxable to the trustee. Where taxes are imposed at the level of the trust, the beneficiary is not usually taxed.

Most countries levy taxes not only upon creation of the trust or foundation by way of gift or on death, but also upon a change of beneficiaries and whenever property is distributed from the trust or foundation to the beneficiaries. Moreover, in addition to the charge on distributions, taxes may also be imposed at periodic intervals during the existence of the trust, as is the case, for example, in the United Kingdom.

The Commentary notes that

the Article may have to be modified to cover charges imposed by some States on events occurring subsequent to the creation of a trust, usufruct, fideicommissum or foundation because some States may take the view that the terms ‘estate’ and ‘gift’ are not sufficiently comprehensive to cover such charges.<sup>692</sup>

The drafters thus envisaged broad coverage under the terms “estate” and “gift”, subject to limiting specifications in the particular treaty. The Model Commentary remarks:

Due to the differences in the civil and taxation laws of Member countries, it was not possible to insert in the Convention provisions which would be acceptable to all States. It is easier to decide in bilateral negotiations whether and to what

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<sup>690</sup> OECD Estates, Inheritances and Gifts MC, Art 2(2), m.no. 2 et seq.

<sup>691</sup> Id on Art. 1, m.no.16.

<sup>692</sup> Id. on Art. 1, m.no. 28.



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extent two States may need special rules. Contracting States are, therefore, left free to insert special provisions in their bilateral conventions to deal with these problems.<sup>693</sup>

No guidance is provided as to whether such transactions may fall under either estate, inheritance and gift tax treaties, or income and capital tax treaties – or possibly both. This lack of guidance in the Model Commentary, however, does not diminish the importance of using all available materials to derive autonomous meaning for the respective treaty.

The Model text and Commentary provide no guidance as to the distinction between income and gifts/inheritorances in the case of distributions from trusts and private foundations to beneficiaries. Where payments are made from a trust or foundation established in one country to a beneficiary resident in the other country, the country of residence of the beneficiary might treat the distribution as income from capital, while the country of establishment of a foundation treats distributions as donations. Most treaties try to avoid such conflict of classification at the stage of treaty negotiations. The tax treaties of Austria with Germany, Ireland and Australia, for example, regard all distributions from Austrian foundations as dividend income if the income is categorized as such by the contracting party's domestic law.<sup>694</sup> The founder's country of residence, however, may also levy gift taxes.

It is thus clear that the object and purpose of tax treaties is best effected by way of interpretation attempting to realize common conceptual premises underlying the Model treaty texts. Inferences should be drawn from the scope of application of the Income and Capital MC to determine the scope of the Estates, Inheritorances and Gifts MC, and vice versa. Although there are vast discrepancies in terminology and concepts in domestic laws, interpretation should to the largest possible extent seek to derive autonomous concepts for purposes of treaty application and avoid application of more than one treaty between the same contracting parties where irreconcilable results in terms of the allocation of taxing rights may be the consequence.

### **2.3. Income/capital vs estates/inheritorances/gifts**

At first glance, it does not appear to be a challenge to grasp the different areas of taxation that led to the introduction of a separate OECD Model text dealing with estates, inheritorances and (subsequently) gifts. The concepts of estates, inheritorances and gifts as well as income and capital are universally known. However, tax systems around the world are vastly different in structure and often do not distinguish when it comes to the imposition of taxes.

Some countries include gifts as part of taxable income, while others even tax gifts in the same manner as capital on the theory that gifts do not constitute regularly accruing gains. Countries that do not levy estate taxes sometimes impose taxes on a "deemed" disposition on death; an example is Canada.<sup>695</sup>

The Estates, Inheritorances and Gifts Model Commentary gives no substantive guidance, but merely notes: [I]t is obvious that the effort to eliminate double taxation between Member countries needs to go beyond the field of *periodic* taxes on income and capital.<sup>696</sup> It goes on to state that "taxes on estates and inheritorances and on gifts are imposed only on specific events."<sup>697</sup>

The 1927 Draft Bilateral Convention submitted by the League of Nations Technical Experts, after laying down the allocation provisions regarding the various items of income giving rise to "direct impersonal or personal taxes", stated the following: "The principles laid down in the preceding articles shall be applicable, *mutatis mutandis*, to the *recurrent* taxes on total wealth, capital, or

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<sup>693</sup> Id. on Art. 1, m.no. 29.

<sup>694</sup> See further Feyl/Helbich/Leitner/Tanzer, "'Privatstiftungen' - The Austrian Version of Trust", *Bulletin for International Fiscal Documentation* 2004, 435 (441).

<sup>695</sup> See Sec. 70(5) of the Canadian Income Tax Act.

<sup>696</sup> 1982 Commentary on the Model Double Taxation Convention on Estates and Inheritorances and on Gifts, Introductory Report by the Committee on Fiscal Affairs - Implementation of the 1966 Estate Tax Draft, m.no. 5 (emphasis added).

<sup>697</sup> Id., m.no. 6.

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increments of total wealth, according as these taxes are personal or impersonal.” (emphasis added) Taxes on income and capital are thus delineated from estate and gift taxes in that the latter are typically levied on a singular rather than a regularly or sporadically recurring event such as income.

From this it can be concluded that periodicity is considered a characteristic element of taxes on income and on capital. Income as covered under income and capital tax treaties is usually a recurring item, with the exception of capital gains per the separate capital gains article, which also includes a single inflow.<sup>698</sup>

In the case of the Canadian tax on a deemed gain in the event of death, unless said tax is included via Art. 2(2), the result of autonomous treaty interpretation is that this tax comes within the scope of the Estates, Inheritances and Gifts MC. The fact that no treaty was concluded that would deal with estate, inheritance and gift taxes cannot be determinative. Expanding the scope of an existing income and capital tax treaty would go against the express object and purpose of the Model texts

that also in the case of taxes on estates and inheritances and on gifts that persons in each Member country who engage in commercial, industrial or financial activities in the other Member countries, or more generally, who own property in such countries, should have their fiscal situation clarified, standardized and made secure through the application by all Member countries of common solutions for eliminating double taxation.<sup>699</sup>

Not least, such practice of expanding existing income and capital tax treaties would be against the consensus reached by the parties concerned.

The Model Commentary mentions that “Member countries desirous of concluding bilateral conventions applying to both taxes on income and capital, and taxes on estates and inheritances and on gifts, may combine the two Model Conventions.”<sup>700</sup> Treaties have rarely pursued this option; an example of a treaty combining both income tax and estate and inheritance taxes is the 1995 Denmark–Germany Tax Treaty. This treaty is unusual in that Art. 2 is headed “Scope of the Convention” and deals not only with the taxes covered but also the persons covered as regards income taxes and estate and inheritance taxes covered. Moreover, the taxes covered are not listed but rather described generally – a practice that is very uncommon in current treaties.

The distinctions that prompted the creation of a separate Model Convention for estates, inheritances and gifts should be given effect even where the parties involved have chosen not to conclude a treaty in the area of estates/inheritances and gifts. Delineating the relevant factors, however, is not an easy task. Frequency or periodicity of incidence is not a reliable factor, as it is not unthinkable that gifts might be made periodically; periodic payments may, for example, come in the form of distributions from a trust or foundation as per instructions of the grantor. Policy considerations may be helpful to tip the scale towards either type of tax, but can only give general guidance. Economist F. A. Hayek noted that the transmission of assets after death is part of the family’s role in transmitting society’s standards and traditions, and that inheritances in this sense are redistributive, aiding the equalization of wealth. The same principle applies to transfers among the living. Income taxes, on the other hand, primarily serve the purpose of providing revenue.<sup>701</sup>

A distinctive factor of income was identified by the League of Nations Technical Experts, Professors Bruins, Einaudi, Seligman and Stamp, discussing the allocation of taxing rights under the League of Nations Model, the principles of which are reflected also in the current OECD-based treaty network: “the origin of income is where the intellectual element among the assets is to be found.... The yield or

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<sup>698</sup> However, the Commentary notes that *taxes on capital gains on the transfer of immovable property, of securities, of shares or the like, irrespective of whether or not such transactions are made for full consideration*, are not regarded as gift taxes. Capital gains of this nature are thus singled out to come exclusively under the Income and Capital Model.

<sup>699</sup> Preceding note, m.no. 8.

<sup>700</sup> 1982 Commentary on the Model Double Taxation Convention on Estates and Inheritances and on Gifts, Introductory Report by the Committee on Fiscal Affairs - Presentation of the 1982 Estate Tax Model, m.no. 14.

<sup>701</sup> F. A. Hayek, *The Constitution of Liberty* (1960) 91 et seq.

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acquisition [of wealth] is due ... not only to the particular thing but to the human relations which may help creating the yield.”<sup>702</sup>

The intellectual element is thus the key component in the production of income.<sup>703</sup> Income is “earned”<sup>704</sup> and most commonly derived on the market.<sup>705</sup>

The Model Commentary on Art. 22 of the Income and Capital MC speaks of taxes on capital “to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties.” The term “taxes on capital” therefore does not encompass taxes on estates, inheritances or gifts.<sup>706</sup> The OECD Model Commentary to Art. 22 (Capital) comments on the scope of the article as follows: “Art. 22 applies only to taxes on capital within the meaning of Art. 2. This term does neither include taxes on estates, inheritances or gifts (for which there are separate tax treaties in some instances) nor transfer duties.”<sup>707</sup> The primary point of distinction between taxes on capital and estate taxes is thus that the latter are triggered in the event of death. Where the parties have chosen to conclude a separate treaty on estate, inheritance and gift taxes, delimitation of the respective scope of each treaty is necessary. As these two types of treaties are intended to complement each other with respect to the areas covered, effective treaty application presupposes that there be no overlaps in substantive scope.

Another factor to delimit taxes on capital from estate, inheritance and gift taxes is to recognize that the common characteristic of the latter is the transfer of value, measured by the diminution in value of the transferor’s property or estate, or, in some countries, by the increase in value of the transferee’s property. Taxes on capital, on the other hand, are typically based on the possession of wealth rather than its transfer.

The Model text or Commentary do not provide clear parameters to delimit gifts from income. In fact, as noted previously, various countries do not levy separate gift taxes, but include transfers in the nature of gifts in the income basis. Where “the income tax” is listed in the treaty, and either contracting party subjects gifts to the same tax treatment as income, factors commonly used to identify a gift are the isolated nature of the receipt, its general unpredictability and a lack of control over its receipt on the part of the recipient. These factors are helpful in the treaty context as well, as neither the Model text nor the Commentary define “gifts”. The question of whether to classify a transfer either as income or as a gift, and the consequences of this classification for treaty application, are particularly relevant in the context of instruments like trusts and foundations, which have as their purpose the transfer to one or more beneficiaries.

Taxes on gifts *inter vivos* referred to in the Model Commentary include all taxes which are levied on gifts (other than *mortis causa*) “or other gratuitous transfers of property”.<sup>708</sup> Gratuity appears to be satisfied where there is a transfer for “no, or less than full, consideration”. Intent of the donor or the beneficiary are not considered but may be a useful factor in delimitation. Where no gift was intended (a concept referred to in some countries as the donor’s *animus donandi*, i.e. intent to confer a gift), there presumably is a bargain that cannot be classified as a unilateral gift from a donor to a beneficiary.

While the donor’s intent may influence the analysis, its core is the determination that there is an accretion to wealth to the beneficiary (and corresponding decrease in wealth on the part of the donor). The accretion occurs gratuitously, i.e. it is not “earned” by the recipient. Payments under life insurance or pension plans, for example, would qualify as gifts if paid to a third party beneficiary.

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<sup>702</sup> Bruins et al., Report on Double Taxation, submitted to the Financial Committee, League of Nations, Geneva, 5 April 1923, E.F.S. 73 (F. 19), at 20 and 23.

<sup>703</sup> See also Kemmeren, “Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach”, *Bulletin for International Taxation* 2006, 430 (434).

<sup>704</sup> O. Bühler, *Prinzipien des Internationalen Steuerrechts: Ein systematischer Versuch*, 2nd edn. (1964) 155.

<sup>705</sup> Cf. above deliberations and further references to Ruppe’s “Markteinkommenstheorie” in Part III, Chap. B.1.2. of this thesis.

<sup>706</sup> Vogel, Commentary to Art. 22 (1), m.no. 6.

<sup>707</sup> Para. 6 of the OECD Model Commentary to Art. 22.

<sup>708</sup> See also the OECD Glossary of Tax Terms, which defines “gift” as a gratuitous transfer of property.

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Where the recipient is the person paying premiums, the payments are certainly not gifts for tax treaty purposes and their treatment under income tax treaties versus social security conventions should be discussed.<sup>709</sup>

#### **D. Delimitation between the OECD Model Conventions on Income and Capital and on Estates, Inheritances and Gifts**

The preceding analyses have delineated differences in concepts that enable subsumption of a taxable event under either the Income and Capital MC or the Estates, Inheritances and Gifts MC. In his article “Taxes covered”,<sup>710</sup> Lang identified possible concurring applicability where the parties have concluded both types of treaties and calls attention to the fact that this may lead to incoherent allocation of taxing rights or “double non-taxation” of the same event. The earliest comprehensive study of cases of overlaps in the material scope of estate, inheritance and gift tax treaties and income and capital tax treaties was provided by Franz Philipp Sutter.<sup>711</sup> More recently, Adolfo Jiménez dealt with examples of such overlaps and how to resolve them.<sup>712</sup> The following considerations aim to add to the discussion and draw conclusions based on the concepts analysed in the preceding chapter.

While the estate, inheritance and gift tax aspect of the avoidance of double taxation is intended to complete protection in the area of income and capital, each of the OECD Model Conventions stands on its own. The texts are not coordinated in that parallel application of both treaties to the same taxable event may lead to contradictory results. In cases where both types of treaties appear to be potentially applicable, subsumption of the levy at issue under the treaty concepts of “income and capital” or “estates, inheritances and gifts”, respectively, should lead to the application of one of the treaties. Even where the parties have concluded only one type of treaty, it is important to interpret the treaty as part of the international tax regime and give effect to the international concepts and basic delineations that led to the adoption of two separate Models.

The Income and Capital MC can generally be seen to aim at events that involve the taxpayer’s exposure to the market and an “intellectual element” or enjoyment of his/her capital. The Estates, Inheritances and Gifts MC, on the other hand, deals with “windfall gains”, which are based on a gratuitous transfer rather than “earned”.

Elements of the common international concept of estate, inheritance and gift taxes can be derived by way of contrast to the Model Commentary description of taxes on income and capital: the Estates, Inheritances and Gifts MC covers gratuitous transfers that trigger taxation upon the transfer event rather than on a regular (yearly) basis. Ambiguities can often be resolved by way of adhering to these general principles:

##### **1. Resolving overlaps in substantive scope**

At first blush, nothing suggests that there might be overlaps in substantive scope as between income and capital tax treaties and estate, inheritance and gift tax treaties. However, the seemingly straightforward distinction in scope is deceiving. As was laid out in the preceding chapter, several countries do not distinguish between income and gifts and tax the recipient of a gift on the value of the gift received at the respective applicable rate. Some countries levy capital gains taxes on occasion

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<sup>709</sup> See the deliberations supra in Part III, A., 1.8.

<sup>710</sup> M. Lang, “‘Taxes Covered’ - What is a ‘Tax’ according to Art. 2 OECD Model Convention?”, *Bulletin for International Fiscal Documentation* 2005, pp. 216 et seq.

<sup>711</sup> Sutter, “Der sachliche Anwendungsbereich des ErbSt-Musterabkommens”, in Aigner et al. (eds.) *Erbschaftssteuern und Doppelbesteuerungsabkommen* (2002) 41.

<sup>712</sup> 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”, *Bulletin for International Fiscal Documentation* October 2005, p. 432.

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of death rather than estate or inheritance taxes. Some countries levy “exit taxes”<sup>713</sup> where a transferor’s death leads to the shares being transferred to foreign beneficiaries.

Where the countries do not specify what is meant by “income taxes” as listed in Art. 2(3) and/or described in paras. 1 and 2, it seems the scope of the income tax treaty might also cover gifts taxed as part of the income tax under internal law. On the other hand, one could argue that capital gains taxes or an “exit tax” levied at death should fall outside the scope of an income and capital treaty when levied at death. However, if internal classifications were given effect in this way in treaty interpretation, if one of the contracting parties later were to introduce a separate gift tax regime and carve out what was formerly part of the income tax basis, or introduce an estate and gift tax, disputes among the contracting parties could erupt as to whether such taxes classify as “substantially similar” in basis to the taxes covered under the existing treaty.

This thesis submits that the reference to “substantially similar” taxes in treaty provisions corresponding to Art. 2(4) of the OECD Model texts cannot transgress the conceptual boundaries set by way of the basic delineation between common international concepts of “taxes on income and capital” and “taxes on estates, inheritances, and gifts” in the OECD Model texts.

There is a clear intention by the drafters of the Commentary to the 1982 Estates, Inheritances and Gifts Model that there be a close relationship between the Income and Capital MC and the Estates, Inheritances and Gifts MC: the Model Commentary, describing the process of creating a second Model Convention dealing with the area of estate, inheritance, and gift taxes, states that

although there are many analogies between the two ... [i]t seemed advisable in 1966 to establish a Draft Convention for estate and inheritance taxes which would constitute a self-contained document with no references to the 1963 Income Tax Draft. The same was true of the Commentaries on the Articles, which only exceptionally contained references from one draft to the other.<sup>714</sup>

The Model Commentary to the Estates, Inheritances and Gifts Tax Treaty further stresses that “concepts which are expressed by the same words in both Model Conventions must each be taken to have the same application, due regard being had, wherever appropriate, to the different nature of the forms of taxation in question.”<sup>715</sup> The concept of “tax” in both Model treaties can be seen to be identical. Therefore, unless the parties express otherwise, “required” levies like registration fees or stamp duties are outside the substantive scope of tax treaties.

“Exit taxation” regarding the value of shares being transferred<sup>716</sup> may be triggered as part of income taxation<sup>717</sup> where a transferor’s death leads to the shares being transferred to foreign beneficiaries. Disputes may thus arise as to whether such transfers are covered by an estate and gift tax treaty rather than an income and capital tax treaty. Parallel application of both treaties may cause conflicts, as Art. 7 of the OECD’s Estates, Inheritances and Gifts MC gives exclusive taxing rights to the residence state of the transferor, while Art. 21 of the Income and Capital MC confers exclusive taxing rights on the state of residence of the beneficiary.

It is therefore vital to recognize that the tax burden underlying an “exit tax” of this type is not imposed on the accretion to wealth at beneficiary level. The aim of such taxation is to capture any inherent gain preserved in the basis of the stock, and thus in fact to tax an accretion to wealth to the transferor. Tax treaties tie in with existing tax burdens, so that it can be concluded that such taxes cannot come within an estate, inheritance and gift tax treaty that may exist between the parties concerned. The result is in principle independent of the denomination of taxes of this kind under a contracting party’s internal law.

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<sup>713</sup> See supra the analysis of “exit taxation” in the context of income and capital tax treaties.

<sup>714</sup> 1982 Commentary to the OECD Estate, Inheritance, and Gift Tax Model, Presentation of the 1982 Estate Tax Model, m.no.13.

<sup>715</sup> Id., at m.no. 14.

<sup>716</sup> See supra the analysis of “exit taxation” in the context of income and capital tax treaties, Part III, Chap. B. 1.3.3.

<sup>717</sup> An example is Austria; see further Toifl, *Wegzugsbesteuerung*, p. 60.

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This approach seems contrary to the above-discussed case regarding the introduction of capital gains tax in Australia, where a recent Australian court decision<sup>718</sup> held these taxes to be “substantially similar” in nature to the income taxes covered under its existing treaties. The Australian capital tax, however, was introduced as part of the domestic income tax law and provided that an indexed part of certain gains was included in “assessable income”, defined under domestic law also to include ordinary income, and in fact forming, after certain deductions, a part of taxable income. The Court’s decision thus stands on solid grounds. Conversely, where a country carves out a part of its income tax base to then subject it to different tax treatment, there is arguably no substantial similarity; in consequence, gift taxes introduced in this way would not come within treaty protection unless the parties decided to amend the existing treaty accordingly or conclude an estate, inheritance, and gift tax treaty.

The respective treaties were intended to operate independently of each other, which suggests that overlaps in substantive scope need to be resolved not only where the contracting parties have concluded both types of treaties, but also where there is only one type of treaty. As noted above, the frequent decision in treaty practice not to conclude an inheritance and gift tax treaty cannot lead to an existing income and capital tax treaty being interpreted to encompass also estate, inheritance and gift taxes.

Nevertheless, problems of genuine overlaps may arise in the context of trusts and foundations: distributions of a trust or foundation to its beneficiaries may be taxed under a country’s income tax law while exempted from gift taxation. An example is Austria, where private foundations have existed since 1993. At that time, the Inheritance and Gift Tax Act was amended to exempt distributions to beneficiaries, which otherwise would have been subject to the inheritance and gift tax; the Individual Income Tax Act was amended correspondingly to include a special income tax liability. The distributions are subject to income tax at the level of resident as well as non-resident beneficiaries.<sup>719</sup> In the case of foreign beneficiaries, the withholding tax may be reduced by a tax treaty. Although such distributions are taxed under Austria’s Individual Income Tax Act, it is not at all clear that income and capital tax treaties are applicable. The fact that taxes are levied under the banner of an individual income tax is not per se sufficient for tax treaty application purposes.

Coverage can be presumed where the list in Art. 2(3). refers to the individual income tax and this tax contained the tax liability with respect to distributions from private foundations to beneficiaries at the time the treaty was concluded. However, as regards inheritance and gift tax treaties concluded before 1993, distributions from private foundations to beneficiaries could be seen to be covered as donations inter vivos or by reason of death. Moreover, it could be argued that the tax liability created under the Austrian Income Tax Act in respect of these distributions are “substantially similar” to parts of the inheritance and gift tax as per Art. 2(4) of the inheritance and gift tax treaty.

This is an example of situations envisaged in Art. 2(4), last sentence, according to which the parties are to notify each other of changes in their respective domestic tax laws. It used to be subject to dispute between Austria and its treaty partners whether distributions from an Austrian foundation to the foreign beneficiary qualify as dividends under Art. 10 of the OECD Model Tax Convention or whether they qualify as other income under Art. 21 of the OECD Model. The prevalent view, which seems to be accepted by the Austrian tax authorities, is that such distributions do not fall under Art. 10 but qualify as other income under Art. 21, which exempts the distributions from Austrian withholding

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<sup>718</sup> *Virgin Holdings SA v. Commissioner of Taxation*, High Court of Australia, FCA 1503, 10 October 2008.

<sup>719</sup> Considerable changes in the taxation of private foundations were recently effected under Austrian law; in the past, distributions of an Austrian private foundation to the founder or other beneficiaries were subject to a 25% Austrian withholding tax, even where the substance of the assets that had been originally transferred to the foundation was redistributed. As of 1 August 2008, distributions are generally subject to Austrian withholding tax only to the extent profits and capital gain have been generated in the foundation.

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tax.<sup>720</sup> Some of Austria's tax treaties, however, regard all income as dividend income if the income is categorized as such by the domestic tax law of the beneficiary's state of residence.<sup>721</sup>

In accordance with the above analysis on the character of dividend income, the characterization as dividend income appears to require only that the payment not be treated as deductible to the private foundation. Some of the treaties that subsume distributions by private foundations under Art. 21 (other income) provide that they are subject to tax in the source state (Austria), but that credit must be given in the residence state.<sup>722</sup> Under Art. 21 of Austria's treaty with the United Arab Emirates, Austria has exclusive taxing rights. Under all its other treaties, Austria has no right to tax distributions by a private foundation to individuals or companies resident in the other state under a provision comparable to Art. 21 of the OECD Model.<sup>723</sup> However, were an inheritance and gift tax treaty applied (e.g. due to the fact that the residence state of the beneficiary treats the distribution as a gift, or under a "substantially similar" argument where the estate, inheritance and gift tax treaty precedes changes to the Income Tax Act), the result would be that Austria is afforded exclusive taxing rights under a provision corresponding to Art. 7 of the OECD Estates, Inheritances and Gifts MC.

Depending on the treaty, contradictory results or double non-taxation may be the result. Lang made the point that double non-taxation may be perfectly in line with the object and purpose of tax treaties when one contracting state does not have taxing rights and the other contracting state does not exercise its taxing rights for domestic reasons, but that it is not reconcilable with the object and purpose of tax treaties to arrive at double non-taxation due to the simultaneous application of both OECD Models.<sup>724</sup>

Where the treaty partners concluded an income and capital tax treaty modelled on the OECD Model Convention, and neither of the contracting parties' internal tax laws impose estate, inheritance and gift taxes, but subject "any accession to wealth" to income tax, such broad internal concepts would appear to suggest coverage of taxes levied on gifts and inheritances. Such interpretation, however, is wrong and potentially causes problems regarding future developments of tax treaty dynamics between the parties. If one of the parties later decided to introduce an inheritance and gift tax, the state of residence of the donee/beneficiary could argue that the tax is "substantially similar" to the income tax under the existing treaty, and that Art. 21 of this treaty confers exclusive taxing rights to the recipient's residence state. An estate, inheritance and gift tax treaty modelled on the OECD Model, however, would provide for donation at source under Art. 5 or Art. 7, depending on where the transferor resides.

Therefore, an application of the income and capital treaty to taxes that qualify as inheritance/gift taxes per common international concepts underlying the OECD Models would give rise to double taxation where a treaty partner does not agree to the other's argument that a newly introduced tax is "substantially similar" to taxes covered under an existing treaty.

Similar problems could arise where the parties have concluded both an income and capital and an estate, inheritance and gift tax treaty, and either party subsequently changes its tax laws: a contracting party may subject beneficiaries of distributions from a trust to income tax, but subsequently change its legislation to subject the beneficiary to inheritance and gift taxes. Double taxation may be the result where one of the parties sees the income and capital treaty as applicable, while the other party applies the estate, inheritance and gift tax treaty. Feasible results can only be achieved by way of treaty interpretation that looks to the common international concepts expressed in international tax language:

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<sup>720</sup> Cf. Feyl/Helbich/Leitner/Tanzer, "Privatstiftungen'- The Austrian Version of Trust", *Bulletin for International Fiscal Documentation* 2004, 435 (441).

<sup>721</sup> Examples are Austria's treaties with Australia, Germany and Ireland.

<sup>722</sup> This is provided in Austria's treaties with Brazil (Art. 21), Malaysia (Art. 21), Thailand (Art. 22), Japan (Art. 19) and Pakistan (Art. 17(1)).

<sup>723</sup> See e.g. Austria's income tax treaty with India (Art. 17) as well as the treaty with the United States (Art. 21).

<sup>724</sup> M. Lang, "Taxes Covered' - What is a 'Tax' according to Art. 2 OECD Model Convention?", *Bulletin for International Fiscal Documentation* 2005, 216 (218).

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Did the beneficiaries receive the payments gratuitously, i.e. as third party beneficiaries without prior corresponding obligations that might point to “earned income”? Are the payments made “by reason of death”, e.g. under a will as distributions from a testamentary trust? Are the payments recurring or do they constitute a transfer on special occasion? Such are the factors to be analysed so as to attain proper treatment under either of the international treaties.

As previously mentioned, the function of Art. 2(4) cannot be to change the substance of what is covered under the treaty; it is geared towards accommodating situations where the same taxable item is taxed in substantially the same way.

A unique yet very feasible approach is taken in the US–Canada Income Tax Treaty of 1980, as amended in 1995. It is the first tax treaty to address estate tax inequities that arise between a country that levies estate or inheritance taxes and a country without estate or inheritance taxes.<sup>725</sup> The United States imposes an estate tax on the value of assets transferred at death, whereas Canada imposes an income tax on 50% of the unrealized gains on capital property deemed sold at death. To further complicate matters, the US estate tax applies to both US citizens and residents, while Canada's income tax is based only on residence. A US citizen who is a resident of Canada at death is subject to tax in both countries on all assets. In addition, each country taxes non-residents on transfers of certain assets considered located within that country. Due to the conceptual difference between income taxes on the one hand and estate/inheritance taxes on the other hand, neither contracting party's tax laws allow a credit for the taxes imposed at death by the other party. The US-Canada treaty mitigates resulting inequities with provisions that provide a foreign tax credit for the Canadian income tax on some or all of the US estate tax paid on assets situated in the United States.<sup>726</sup> For US estate tax purposes, it also provides a foreign death tax credit for the Canadian income tax assessed on the deemed sale at death of assets located in Canada. However, the treaty does not provide gift tax relief.

An interpretation that recognizes the distinction in international tax treaty concepts between “income and capital” and “estates, inheritances and gifts” provides consistent results that are in line with the object and purpose of tax treaties. This approach leaves room for the parties to make provisions for ambiguities that may arise in treaty application due to discrepancies in domestic tax laws. The international treaty network and its coherence in terms and policies deserves an interpretive approach that seeks to give effect to existing common international concepts and advances the goal to harmonize international taxation.

## **2. A note on the non-discrimination provisions**

Art. 10 of the OECD Model Treaty on Estates, Inheritances and Gifts provides that nationals of a contracting state, wherever they are domiciled, shall not be subjected in the other contracting state to any taxation which is other or more burdensome than the taxation and connected requirements to which nationals of the other contracting state in the same circumstances may be subjected.

Despite Art. 1 of the Model Estates, Inheritance and Gifts tax treaty, which provides that the treaty applies to “estates and inheritances where the deceased was domiciled, at the time of his death, in one or both of the Contracting States”, the expression “wherever they are domiciled” in Art. 10 implies that the non-discrimination provision is accorded stand-alone status within the treaty. This is consistent with the general understanding of the non-discrimination principle of the OECD Tax Committee, which takes the position that this principle should apply to nationals of contracting states, irrespective of their residence.<sup>727</sup>

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<sup>725</sup> See also Protocol Amending the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as amended by the Protocols Signed on June 14, 1983, March 28, 1984, and March 17, 1995.

<sup>726</sup> See Treaty Art. XXIX B.6.

<sup>727</sup> Juilhard p. 201



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The wording of the provision is not as explicit as that of Art. 24 of the OECD Income and Capital Model text. As laid out above in this study, the non-discrimination provision in the Income and Capital MC applies to “taxes of every kind and description”, which appears to include also estate, inheritance and gift taxes. A taxpayer may thus seek to obtain discrimination protection under the Income and Capital MC where no treaty in the area of estate and gift taxes was concluded, or where such treaty does not contain a non-discrimination provision.<sup>728</sup> Moreover, the scope of the non-discrimination provision in estate, inheritance and gift taxes is often limited to residents under the treaty.<sup>729</sup> Some treaties contain a non-discrimination provision that is only applicable to taxes targeted by the treaty.<sup>730</sup>

Unlike cases involving substantive scope, the object and purpose of non-discrimination provisions in principle seems to permit overlaps of both Models, so that taxpayers may invoke discrimination protection under either the Income and Capital MC or the Estates, Inheritances and Gifts MC. Nationals of a country that has concluded an income tax treaty whose non-discrimination provision applies to non-residents may thus benefit from this principle not only for income tax purposes, but also in estate, inheritance and gift tax matters. Nevertheless, the OECD Tax Committee has stated that it is necessary to insert a non-discrimination clause in estate, inheritance and gift tax treaties because the respective income tax treaty may not be applicable in certain instances, e.g. where a treaty is unilaterally terminated by a contracting party.

### **Interpretive results and outlook**

The thesis focused on the structure and content of Art. 2 of the OECD Model Conventions with respect to taxes on income and capital as well as taxes on estates, inheritances and gifts. The objective was to draw a clearer picture of the “taxes covered” by tax treaties worldwide that have adopted the Model texts.

A basic thread throughout the study is the view that bilateral treaties that adopt the OECD Model formulations express a basic common international consensus. An interpretation of the Model texts that takes into account the international context and is therefore equally informed by textual, systematic, historical and teleological factors is the key to determining the substantive scope of tax treaties. Courts worldwide have increasingly recognized the existence of an “international tax language”, especially in cases where undefined treaty terms have no equivalent in a treaty party’s domestic tax system.

The “interpretive” provision in Art. 3(2) has sparked controversy about its application from early on; representatives of the OECD Member countries addressing the Fiscal Committee during a 1965 Session noted that “the Committee has created a source of difficulty that it must now remove.” While the provision has to date not been removed, it is clear from the object and purpose of international tax treaties that it cannot support instant recourse to domestic tax law concepts.

The Model Commentaries, while certainly a primary resource in interpretation, merely display interpretive conclusions, without a hint as to the grounds from which they were derived. The thesis therefore draws on Reports and Minutes documenting the drafting history of Art. 2 to shed light on the concepts underlying formulations that have remained virtually unchanged throughout tax treaty history. The thesis argues that the fact they were originally classified as “restricted” and thus not readily accessible to the public at large in no way disqualifies them, from the perspective of international law, as a valuable resource in interpretation.

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<sup>728</sup> This is the case with several treaties concluded by Austria, the United Kingdom, Sweden and Switzerland.

<sup>729</sup> See e.g. regular practice in estate, inheritance and gift tax treaties concluded by Spain.

<sup>730</sup> This is the case in some treaties concluded by Canada, Spain and the Philippines.

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International agreements entered into by the contracting parties in the areas of world trade law and international social security law as well as the law of the European Communities may need to be factored in when interpreting a given treaty. While EC law explicitly acknowledges the importance of bilateral treaties for the prevention of double taxation, tax treaties as between EC Member States need to be interpreted consistently with the requirements of EC law. Moreover, tax treaty law is closely interlinked with international trade law. Provisions of the GATT and WTO Agreements play a vital role, particularly in the area of non-discrimination. Treaty practice would benefit from further research regarding the intersection of international tax law and international trade law.

The same is true for the relation between tax treaties and bilateral agreements concluded in the area of social security coordination, sometimes called “totalization agreements”. The treatment of social security payments under tax treaties is still to a large extent unresolved, causing a host of uncertainties for the expatriate taxpayer. As between EU Member States, a Regulation coordinating rights to impose social security levies as between the payments applies to any payment that in effect finances a social security scheme. The thesis argues that such payments should not be seen to come within the scope of tax treaties between EU Member States, as any other approach would be in breach of the law of the European Communities. Often, the parties to a tax treaty have also concluded a bilateral social security agreement (“totalization agreement”). Such agreements “totalize” any benefits and aim to relieve double imposition of social security payments on the same income in the case of residents/nationals of one country that perform work in another. Considering the fact that countries increasingly finance their social security systems by way of general taxation, coverage of a social security payment under either treaty appears plausible. The thesis suggests that a levy that does not go to the government’s general budget, being linked to the financing of social security, should in general be seen not to come within treaty scope since the co-ordination rules of the social security agreement may come into conflict with the distributive rules of the tax treaty concluded by the same parties. Government authorities concluding tax treaties usually do not coordinate with authorities concluding social security agreements; more dialogue between these authorities of the contracting parties is therefore desirable.

The matter is complicated by the fact that most social security agreements as well the EC Regulation apply to “present or future” legislation, which is comparable in its effect to Art. 2(4) of the OECD Model. Unclear cases thus arise where a state replaces its contributory social security system by a system that is financed out of general taxation. In the case of such substantial changes, arguably the social security agreement respectively, the Regulation should no longer apply and it needs to be examined whether the tax treaty may be applicable. Where a state has attributed competences over certain levies to government bodies other than the bodies associated with taxation, there is a strong argument that these levies should not be seen to be within the scope of tax treaties.

Contentious cases have arisen among contracting parties primarily as to the meaning of the general description in paras. 1 and 2 in the light of a merely illustrative enumeration of taxes in para. 3 on the part of each contracting party. While the 1969 Report of OEEC Working Party No. 30 concedes that “the general descriptions given in paragraphs 1 and 2 are not too precise and might probably be called to be rather vague”, it is stressed that both paragraphs together are determinative of the taxes to which the Convention applies, while the list in para. 3 merely illustrates the general description. Therefore, where the parties decide to incorporate a general description into their treaty, such description has stand-alone value and provides for broad coverage. As OEEC Working Party No. 30 stated, “taxes not enumerated in paragraph 3 but qualifying for a test under paragraphs 1 and 2 are – under the present O.E.C.D. concept – nevertheless within the scope of the Convention.” Furthermore:

The omission of paragraphs 1 and 2 would primarily affect the position of paragraph 3: under the present scheme, the ‘ultimate responsibility’ for the determination of the subject of the Convention goes with paragraphs 1 and 2; ... [L]eaving out paragraphs 1 and 2 would mean that the scope of the Convention is determined solely by the list of taxes in paragraph 3; and this would imply that the enumeration of taxes therein must be exhaustive.

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On the other hand, the list in para. 3 can go beyond what would be seen as “taxes on income and on capital” in terms of a common international consensus, as the list is a direct expression of the parties’ intent. OEEC Working Party No. 30 commented that

there might exist fiscal charges, fees or other levies with respect to which it could be doubtful whether they are ‘taxes on income (capital)’ within the meaning of the general definition given in paragraphs 1 and 2.... If those levies shall be brought under the Convention then it is – in the opinion of the Working Party – sufficient to enumerate such taxes by name in the list of taxes in paragraph 3. Paragraph 3 has quite obviously the power (although being principally an illustration to paragraphs 1 and 2) to *amplify* the scope of the Convention so that taxes and charges might be included in the Convention even if they were not considered to be ‘taxes on income (capital)’ within the meaning of paragraphs 1 and 2.

Where there is no general description of the taxes covered, a tax not named in the exhaustive list can only come within treaty scope via the provision in Art. 2(4), i.e. where a tax is imposed in addition to, or in place of, the taxes existing at the time the treaty was signed, and such tax is “substantially similar” to the taxes existing at the time of signature. The wording “in addition to, or in place of” is derived from the formulation “new taxes, or taxes replacing those to which the Convention applies” used in the 1957 Report of OEEC WP No. 3. Taking into consideration the purpose of para. 4 to prevent the treaty from becoming inoperative, it is clear that coverage should apply not only to newly created taxes but equally to substantial changes of existing taxes. From the perspective of international law, para. 4 is extraordinary, as it expresses a general commitment of the parties also with regard to future events; this flexibility is vital in the fast-paced world of taxes. OEEC WP No. 30 interpreted para. 4 in the light of paras. 1 and 2 in that “under the present O.E.C.D. concept, taxes being introduced after the signature of the Convention are automatically subject to the Convention, provided they are taxes on income (capital) within the meaning of paragraphs 1 and 2.”

Working Party No. 30 further commented that “a subsequently introduced tax is considered to be ‘identical or substantially similar’ if it is a tax on income (capital) in the meaning of paragraphs 1 and 2. If, however, paragraphs 1 and 2 were omitted, the criterion ‘identical or substantially similar’ could be interpreted only in respect of the taxes enumerated in the list of taxes.” The Working Party’s analysis confirms that in accordance with the purpose of the treaty, it is necessary to look to the taxes listed by both states together as one single unit when determining whether a subsequently imposed tax by either party is substantially similar per para. 4.

Neither the Model Conventions nor the Commentaries thereto specify by what parameters taxes may be classified to be “identical or substantially similar”. The League of Nations Draft Conventions of Mexico and London, whose formulations have influenced the OEEC’s drafting process, referred to taxes “upon substantially the same bases” in the corresponding provision. The designation of a subsequently introduced tax is irrelevant to the determination of its substantial similarity to a tax covered under the treaty. The concept of similarity in para. 4 rather looks to the taxable object, as the treaty as a whole ties in with existing tax burdens of a character laid out in Art. 2(1) and (2) and/or listed in Art. 2(3). The reference in para. 4 to the “time of signature” might have been chosen purposely so as to bring within treaty scope changes occurring during the time period between conclusion and signature of the treaty, thus taking account of the fact that in practice there may be a significant gap between these time periods. While this supposition could not be substantiated via reference to the historical drafting materials, it is certainly in line with the object and purpose of tax treaties.

The application of a treaty to “substantially similar” taxes as per para. 4 is automatic and independent of the requirement laid out in the second sentence of para. 4 for the competent authorities of the contracting parties to “notify each other of any significant changes that have been made in their taxation laws.” No mechanism is provided in the treaty to compel the parties to meet this notification requirement. However, even without express insertion into the treaty this obligation can be seen to exist under the principle of *pacta sunt servanda*, i.e. the requirement for legally binding treaties to be adhered to in good faith. Some of the oldest treaties concluded in the 1920s did not provide for a list of taxes covered but instead incorporated the requirement for periodical exchange of lists of the

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existing taxes in each of the treaty partners, an approach that has since been dismissed for its impracticability.

The purpose of tax treaties warrants a typological, flexible term of “tax” the elements of which can be concretized in bilateral negotiations. Awareness of common international elements of the concept of “tax” can constitute substantial support in the negotiation and application of tax treaties. The most basic common element of the concept of tax in tax treaties was expressed by E. R. A. Seligman, one of the League of Nations Technical Experts who drafted a report for submission to the League of Nations Fiscal Committee which served as a basis for the first Draft Double Taxation Conventions, noted that whenever the payment secures concrete government action or the concession of certain commodities to the individual payer, it is not a “tax” but rather a fee in character and will generally be outside the scope of tax treaties. “Taxes” within the meaning of tax treaties modelled on the OECD texts are involuntary pecuniary burdens imposed by way of government’s sovereignty on all taxpayers, regardless of whether taxpayers make use of a certain good or service provided by government. As identical terms used in both the OECD’s Income and Capital Tax Model Convention and the Estates, Inheritances and Gifts Tax Model Convention should in principle be seen to have the same meaning, the basic concept of “tax” is identical as used in both Models.

The term “tax” has a key function not only in the treaty article on substantive scope but also in the provisions on non-discrimination, exchange of information and assistance in the collection of taxes. The non-discrimination provision is by its very nature designed to apply to any taxes, irrespective of whether they are within the substantive treaty scope, as the purpose of avoiding discriminatory tax treatment goes beyond the allocation of jurisdiction to tax to eliminate double taxation. Similarly, Art. 26 on exchange of information refers to “taxes of every kind and description”; therefore, the extent of information exchange cannot be curtailed by the parties via a narrow provision on substantive scope. However, payments that are not “taxes” within the meaning of the treaty are not covered by the reference in Art. 26. A stringent approach calls for the same conclusions in the context of Art. 27, which provides for assistance in the collection of taxes and broadly refers to “revenue claims”.

A tax treaty requires “more than a mere exchange of paper” in order for treaty protection to apply, as tax treaties tie into taxation events in the sense of an actual tax burden. Whereas the allocation provisions of the OECD Models use words like “paid” and “derived”, too literal a reading would go against the purpose of tax treaties. Income that is deemed to be paid or derived under domestic tax laws (“fictitious income”) and thus causes “real” tax burdens can in principle come within the specific income allocation provisions of tax treaties. “Fictitious” elements of taxes are thus generally creditable under tax treaties.

Nevertheless, tax treaties do not prevent double burdens in situations where one country taxes “fictitious” income, but a subsequent change in circumstances concerning that same taxable base leaves the other state with taxing rights under the treaty that are exercised upon actual realization. Such “economic double taxation” can only be prevented by way of unilateral action. There are no adequate measures available at international level, however, to ensure that a country will take such action.

The notion of taxes on “income and capital” and taxes on “estates, inheritances and gifts” is premised on the basic concept of “tax” in the OECD Model Conventions. An observation that can be made as to the character of “income” in the tax treaty context is that it primarily comprises cash-basis market transactions that effect dominion or control of the taxpayer over the item of income.

The express reference to “recurrent” taxes in the OECD’s Income and Capital Model Commentary apparently aims to delineate taxes on income and capital from taxes on estates, inheritances and gifts. Taxes covered by the Estates, Inheritances and Gifts Model Convention are “one time”- type events rather than recurring impositions, and are imposed on *transfers of property by reason of death*, on the one hand, and taxes on *transfers for no, or less than full, consideration*.

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The phrase “by reason of death” is very broad, but appropriately so in that it captures situations where countries add gifts that are made within a certain period of death to the value of the decedent’s assets for purposes of estate and inheritance taxes. The phrase “for no, or less than full, consideration” describing gifts indicates that transfers that are really in consideration of services provided cannot come within the scope of the Estates, Inheritances and Gifts Tax Model, but would be governed by the Income and Capital Tax Model.

Inferences should be drawn from the scope of application of the Income and Capital MC to determine the scope of the Estates, Inheritances and Gifts MC, and vice versa. As mentioned, income is “earned” and most commonly derived on the market. A distinctive factor of income was identified by the League of Nations Technical Experts, Profs. Bruins, Einaudi, Seligman and Stamp, discussing the allocation of taxing rights under the League of Nations Model, the principles of which remained constant through today’s OECD-based treaty network: “[t]he origin of income is where the intellectual element among the assets is to be found.... The yield or acquisition [of wealth] is due ... not only to the particular thing but to the human relations which may help creating the yield.”

A key factor to delimit taxes on capital from estate, inheritance and gift taxes is to recognize that the common characteristic of the latter is the transfer of value, measured by the diminution in value of the transferor’s property or estate, or, in some countries, by the increase in value of the transferee’s property. Taxes on capital, on the other hand, are typically based on the possession of wealth rather than its transfer. While the donor’s intent may influence the analysis, its core is the determination that there is an accretion to wealth to the beneficiary (and corresponding decrease in wealth on the part of the donor). The accretion occurs gratuitously, i.e. it is not “earned” by the recipient. Payments under life insurance or pension plans, for example, would qualify as gifts if paid to a third party beneficiary. Where the recipient is the person paying premiums, the payments are not gifts for tax treaty purposes and their treatment under income tax treaties versus social security conventions should be discussed.

The provision on substantive scope carries the weight of the treaty and, given its history of stability in structure and wording as well as the widespread adherence in tax treaty practice, it seems that Art. 2 in its present form in the OECD Model texts is here to stay – as evidenced also by the fact that the US Income and Capital Model Tax Treaty has approximated its wording of the provision on substantive scope to that of the OECD Income and Capital Model Convention.

The determination of the substantive scope of tax treaties should follow coherent principles that take account of the fact that the widespread use of the Model terms has its basis in common international concepts. Much can be gained from a negotiation and subsequent application of tax treaties that entails awareness of the interconnectedness of paras. 1 through 4 of Art. 2, as the decision to give exhaustive character to the list of taxes covered in para. 3, or not to include or to reduce a general description in paras. 1 and 2, is of defining consequence to the scope of treaty protection.

While the thesis has dealt with a variety of issues arising in the context of determining the substantive scope of tax treaties, and sought to derive sustainable principles with a view to common international concepts that have formed the present wording of the provision, it is to be expected that the dynamic field of taxation will bring about ever more and different issues for this key article. To paraphrase Prof. Lang – whose article on “Taxes Covered” inspired this thesis – Art. 2 deserves more attention.

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## **Annex I: The Substantive Scope throughout History**

### **League of Nations Double Taxation and Tax Evasion Report, Geneva, April 1927**

#### *Draft of a Bilateral Convention for the Prevention of Double Taxation*

##### *Article 1*

The present Convention is designed to avoid double taxation in the sphere of direct impersonal or personal taxes, in the case of the taxpayers of the Contracting Parties, whether nationals or otherwise. For the purposes of this Convention the following shall be regarded as impersonal taxes:

- (a)\_
- (b)\_
- (c)\_

For the purposes of this Convention, the following shall be regarded as personal taxes:

- (a)\_
- (b)\_
- (c)\_

#### *I. Draft Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties*

##### *Article 1*

The purpose of the present Convention is to prevent taxpayers of the Contracting States from being subjected to double taxation in the matter of succession duties.

For the purpose of this Convention, the following shall be regarded as succession duties:

- (a)\_
- (b)\_
- (c)\_

### **League of Nations Double Taxation and Tax Evasion Report, Geneva, October 1928**

#### *I. Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes*

##### *Draft Convention NO.Ia*

##### *Article 1*

The present Convention is designed to prevent double taxation in the sphere of direct impersonal or personal taxes, in the case of the taxpayers of the Contracting Parties, whether nationals or otherwise. For the purposes of this Convention the following shall be regarded as impersonal taxes:

- (a)\_
- (b)\_
- (c)\_

For the purposes of this Convention, the following shall be regarded as personal taxes:

- (a)\_

- 
- (b)\_\_\_
  - (c)\_\_\_

*Draft Convention NO.Ib*

The present Convention is designed to prevent double taxation as regards the following specified taxes, in the case of the taxpayers of the Contracting States, whether nationals or otherwise.

- (a)\_\_\_
- (b)\_\_\_
- (c)\_\_\_

*Draft Convention NO.IC*

The present Convention is designed to prevent double taxation as regards the following specified taxes in the case of the taxpayers, whether nationals or otherwise, of the Contracting States:

- (a)\_\_\_
- (b)\_\_\_
- (c)\_\_\_

*II. Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties*

*Article 1*

The purpose of the present Convention is to prevent taxpayers of the Contracting States from being subjected to double taxation in the matter of succession duties.

For the purpose of this Convention, the following shall be regarded as succession duties:

- (a)\_\_\_
- (b)\_\_\_
- (c)\_\_\_

**League of Nations, 1943 Mexico Draft Model Bilateral Convention for the Prevention of Double Taxation of Income**

*Article 1*

1. The present Convention is designed to prevent double taxation in the case of the taxpayers of the contracting states, whether nationals or not, as regards the following taxes:

- a. With reference to State A: ...
- b. With reference to State B: ...

2. It is mutually agreed that the present Convention shall apply also to any other tax, or increase of tax, imposed by either contracting state subsequent to the date of signature of this Convention upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.

**League of Nations, 1943 Mexico Draft Model Bilateral Convention for the Prevention of the Double Taxation of Successions**

*Article 1*

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1. The present Convention, the purpose of which is to prevent the double taxation of successions, applies to all duties and taxes levied, by reason of death, on the estate, or on the transfer of, or the succession to, the estate, of a person who, at the time of his death, had his domicile in one of the two contracting states, whether or not he was a national of that State or the other State, and on the part of such estate that accrues to each heir or legatee.
  2. The duties and taxes to which this Article refers are:
    - a. In the case of State A: ...
    - b. In the case of State B: ...

**League of Nations, 1946 London Draft model Bilateral Convention for the Prevention of the Double Taxation of Income and Property**

*Article I*

1. The present Convention is designed to prevent double taxation in the case of the taxpayers of the contracting states, whether nationals or not, as regards the following taxes:
  - a. With reference to State A: ...
  - b. With reference to State B: ...
2. It is mutually agreed that the present Convention shall apply also to any other tax, or increase of tax, imposed by either contracting state subsequent to the date of signature of this Convention upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.

**League of nations, 1946 London draft model bilateral convention for the prevention of the double taxation of estates and successions**

*Article I*

The present Convention, the purpose of which is to prevent the double taxation of estates and successions, applies to the following duties and taxes:

- a. In the case of State A: ...
- b. In the case of State B: ...

**OEEC, Draft Convention submitted by the Italian Delegate of Working Party No. 3 of the Fiscal Committee, Paris, 10 January 1957**

[FC/WP3 (57) 1, p. 2]

*Article I*

1. This Convention shall apply to:
  - (a) Taxes on total income, on the elements of income and on income derived from the alienation of elements of capital (capital profits); and –
  - (b) Taxes on total capital, on the elements of capital and on increment to capital (excluding taxes which are in the nature of extraordinary non-recurring levies on capital);  
Being taxes imposed on the signature of this Convention, or subsequently thereto, on behalf of the contracting States or on behalf of their political subdivisions and local authorities.



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2. The term “tax”, as used in this Article, means the principal duty of tax, surcharges, interest, costs and all other accessory additional duties, irrespective of the manner in which the same are levied.
  3. The existing taxes to which the Convention is to apply are, in particular:
    - (a) In the case of.....
    - (b) In the case of.....
  4. If either of the contracting States, after the signature of this Convention, should make substantial alterations to the taxes specified in paragraph 3 of this Article or impose further taxes on income or capital, then the competent authority of that State shall notify such alterations or further taxes to the other contracting State within a period of six months.
  5. It is agreed that the competent authorities of both states shall consult together in order to clarify any doubts arising in practice as to the taxes to which the Convention applies, and, in particular, to determine the nature and character of any alterations or further taxes to which the last foregoing paragraph applies.

**OEEC, Draft Convention submitted by the Swiss Delegate**

[FC/WP3 (57) 1, p. 12]

A. Draft Clauses for a Convention

I. With respect to taxes on income and capital

1. The object of this Convention is to avoid the double taxation which might result from the concurrent application in relation to taxpayers of both States, of (State A) and (State B) legislation relating to ordinary and extraordinary taxes on income and capital.
2. For the purposes of this Convention, there shall be regarded as taxes on income and capital all taxes imposed, under (State A) and (State B) taxation legislation, on total income, on total capital, or on the elements of income or of capital, including taxes on profits derived from the alienation of movable or immovable property (capital profits and profits on real property), as well as taxes on increment values or on enrichment.
3. This Convention shall apply to taxes imposed on behalf of one of the two States, of its political subdivisions (constituent States, regions, provinces, cantons, districts, “arrondissements”, circles [“Kreise”], etc.).
4. The existing taxes to which this Convention is to apply are in particular:
  - A. In the case of (State A)
  - B. In the case of (State B)

The taxes specified in the foregoing sub-paragraph comprise, in addition to the principal duty of tax, all additions, interest, costs, and other accessory duties.
5. This Convention shall also apply to all identical or substantially similar taxes which are imposed in future in addition to or in place of the existing taxes. At the end of each year, the taxation authorities of the two States shall notify to each other any amendments which have been made to their respective taxation legislations.
6. The taxation authorities of the two States shall consult together in order to clarify any doubts which may arise as to the taxes to which the Convention ought to apply.

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II. With respect to taxes on estates and inheritances

1. The object of this Convention is to avoid the double taxation which might result from the concurrent application in relation to taxpayers of both States, of (State A) and (State B) legislation relating to ordinary and extraordinary taxes on estates and inheritances imposed on the occasion of the death of a person who at the time of his death was domiciled in one of the two States, as well as to taxes on donations mortis causa.
2. For the purposes of this Convention, there shall be regarded as taxes on estates and inheritances all taxes imposed on the occasion of death, under (State A) and (State B) taxation legislation, in the form of tax on the corpus of the estate, of tax on inheritances or of transfer duties.
3. This Convention shall apply to taxes imposed on behalf of one of the two States, of its political subdivisions (constituent States, regions, provinces, cantons, districts, “arrondissements”, circles [“Kreise”], etc.), and of its local authorities (municipalities or groups of municipalities, etc.), irrespective of the manner or form in which such taxes are levied (direct assessment, deduction at the source, surtaxes or surcharges, additional taxes [“centimes additionnels”], etc.).
4. The existing taxes to which this Convention is to apply are:
  - A. In the case of (State A)
  - B. In the case of (State B)

The taxes specified in the foregoing sub-paragraph comprise, in addition to the principal duty of tax, all additions, interest, costs, and other accessory duties.

5. This Convention shall also apply to all identical or substantially similar taxes which are imposed in future in addition to or in place of the existing taxes. At the end of each year, the taxation authorities of the two States shall notify to each other any amendments which have been made to their respective taxation legislations.
6. The taxation authorities of the two States shall consult together in order to clarify any doubts which may arise as to the taxes to which the Convention ought to apply.

**OEEC, Draft Article adopted by the Fiscal Committee on 4<sup>th</sup> June 1957, on the basis of the proposals included in the Report of WP No. 3**  
[FC/WP 3(57)2 of 2<sup>nd</sup> May 1957]

A. Taxes on income and capital

- (1) This Convention shall apply to taxes on income and capital imposed on behalf of each of the two States or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
- (2) There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on the elements of income or of capital, including taxes on profits derived from the alienation of movable or immovable property (capital profits and profits on real property), taxes on the total amounts paid on wages or salaries by undertakings, as well as taxes on increment values.
- (3) The existing taxes to which this Convention is to apply are in particular:
  - (a) In the case of State A: .....
  - (b) In the case of State B: .....

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- (4) This Convention shall also apply to all identical or substantially similar taxes which are imposed in future in addition to or in place of the existing taxes. At the end of each year, the competent authorities of the two States shall notify to each other such amendments as have been made to their respective taxation legislations.
  - (5) The competent authorities of the two states shall by mutual agreement clarify any doubts which may arise as to the taxes to which the Convention ought to apply.

B. Taxes on estates and inheritances

- (1) This Convention shall apply to taxes on estates and inheritances imposed on behalf of each of the two States or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
- (2) There shall be regarded as taxes on estates and inheritances all taxes imposed on the occasion of death in the form of tax on inheritances, of tax on the corpus of the estate or of transfer duties, as well as taxes on donations mortis causa.
- (3) The existing taxes to which this Convention is to apply are in particular:
  - (a) In the case of State A: .....
  - (b) In the case of State B: .....
- (4) This Convention shall also apply to all identical or substantially similar taxes which are imposed in future in addition to or in place of the existing taxes. At the end of each year, the competent authorities of the two States shall notify to each other such amendments as have been made to their respective taxation legislations.
- (5) The competent authorities of the two States shall by mutual agreement clarify any doubts which may arise as to the taxes to which this Convention ought to apply.

**OECD, 1963 Model Convention with respect to Taxes on Income and on Capital**

Chapter I

Scope of the Convention

Article 2

Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of each Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are, in particular:
  - (a) In the case of (State A):
  - (b) In the case of (State B):
4. The Convention shall also apply to any identical or substantially similar taxes which are subsequently imposed in addition to, or in place of, the existing taxes. At the end of each year, the

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competent authorities of the Contracting States shall notify to each other any changes which have been made in their respective taxation laws.

**OECD, 1966 Model Convention for the Avoidance of Double Taxation with respect to Taxes on Estates and Inheritances**

Chapter I

Scope of the Convention

Article 2

Taxes covered

1. This Convention shall apply to taxes on estates and inheritances imposed on behalf of each Contracting State or one of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on estates and inheritances all taxes imposed on the occasion of death in the form of tax on the corpus of the estate, of tax on inheritances, of transfer duties, or of taxes on donations mortis causa.
3. The existing taxes to which the Convention shall apply are, in particular:
  - a) in the case of (State A): ...
  - b) in the case of (State B): ...
4. The Convention shall also apply to any taxes on estates and inheritances which are subsequently imposed in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify to each other any changes which have been made in their respective taxation laws.

**OECD, 1977 Model Convention for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital**

Chapter I

Scope of the Convention

Article 2

Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are, in particular:
  - (a) (in State A): .....
  - (b) (in State B): .....
4. The Convention shall apply also to any identical or substantially similar taxes which are imposed in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of

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the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

**OECD, 1983 Model Convention for the Avoidance of Double Taxation with respect to Taxes on Estates and Inheritances and on Gifts**

Article 2

Taxes covered

1. This Convention shall apply to taxes on estates and inheritances and on gifts imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on estates and inheritances taxes imposed by reason of death in the form of taxes on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on donations mortis causa. There shall be regarded as taxes on gifts taxes imposed on transfers inter vivos only because such transfers are made for no, or less than full, consideration.
3. The existing taxes to which the Convention shall apply are:
  - a) (in State A) ...
  - b) (in State B) ...
4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

**OECD, 2005 Model Convention for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital**

Article 2

Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are in particular:
  - a) (in State A): .....
  - b) (in State B): .....
4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

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## Annex II: [TITLE]

The treaties used to prepare Annex II were obtained from the IBFD Tax Research Platform, accessed at <http://online.ibfd.org/>. All existing tax treaties in the area of taxes on income and capital concluded between 1921 and 1938 are listed.

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<b>Parties and Year of Conclusion</b>	<b>Provision on Taxes Covered</b>
Czechoslovakia Germany, 1921	General description of taxes covered ( <i>income and property</i> ), reference to future taxes, agreement of the parties in unclear cases as to the taxes covered.
Austria Czechoslovakia, 1922	General description ( <i>income and property</i> ), future Czechoslovakian tax referred to in the capital article, agreement of the parties in unclear cases.
Austria Germany, 1922	Direct taxes ( <i>income and property</i> ), reference to future taxes, <i>excess profits and increase of capital</i> mentioned, agreement in unclear cases.
Czechoslovakia Hungary, 1923	General description of taxes covered ( <i>income and property</i> ), agreement in unclear cases.
Germany Hungary, 1923	General description ( <i>property and revenue, profits</i> ), agreement in unclear cases.
Czechoslovakia Italy, 1924	General description ( <i>income</i> ) with distinction between <i>direct impersonal taxation on income</i> and <i>direct personal taxation on income</i> , distributive rules regarding specified taxes on capital.
Austria Hungary, 1924	General description ( <i>property and revenue</i> ), <i>extraordinary capital taxes</i> mentioned, agreement in unclear cases, distributive rules regarding specified taxes on capital.
Czechoslovakia Poland, 1925	No express provision on taxes covered, but reference to direct taxation as well as some specific taxes in the various distributive articles; only taxes on income.
Germany Italy, 1925	General description ( <i>income</i> ) with definition of income: <i>direct taxation which is levied direct on income, gross or net, or on personal capital</i> ; distinction between direct impersonal taxation on income and direct personal taxation, defined: Direct taxation levied in respect of single objects liable to taxation and on the basis of their economic connection with the territory of the state, shall be regarded as “impersonal taxation”. Direct taxation levied on the whole body of objects liable to taxation – income or property – and based on the fact that they belong to a single taxable person or on that person’s nationality, residence or sojourn, shall be regarded as “personal” taxation. Non-exhaustive list with regard to impersonal taxation.

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Hungary Italy, 1925	General description ( <i>income and capital</i> ); non-exhaustive list, separate article on <i>increment</i> .
Austria Switzerland, 1927	General description ( <i>direct taxes on income and capital</i> ).
Germany Sweden, 1928	General description ( <i>income and capital</i> ), reference to inclusion of future taxes, <i>increments</i> excluded from coverage.
Belgium Luxembourg, 1931	Exhaustive list (income).
Finland Sweden, 1931	General description ( <i>income and capital</i> ) with <i>gain</i> explicitly included and <i>increment taxes</i> explicitly excluded, non-exhaustive list of taxes covered.
Belgium France, 1931	General description ( <i>income</i> ) and exhaustive list, <i>imputed rent</i> included and <i>business profits</i> excluded in the distributive rules.
Belgium Italy, 1931	General description ( <i>income</i> ) and exhaustive list, <i>imputed rent</i> included and <i>business profits</i> excluded in the distributive rules.
France Italy, 1931	General description ( <i>income</i> ) and exhaustive list, <i>imputed rent</i> included and <i>business profits</i> excluded in the distributive rules.
Austria Poland, 1932	General description ( <i>income and capital</i> ).
Hungary Romania, 1932	Exhaustive list with explicit exclusion of Hungarian property tax.
France United States, 1932	Exhaustive list (taxes on income).
Denmark Sweden, 1932	General description ( <i>income and capital</i> ) with explicit mention of <i>gain</i> ; non-exhaustive list.
Belgium Netherlands,	Exhaustive list (taxes on income and capital), <i>imputed rent</i> included and <i>business profits</i> excluded in the distributive rules.

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1933	
Germany Switzerland, 1934	General description ( <i>income and capital</i> ), <i>increase in capital</i> explicitly included; non-exhaustive list.
Netherlands Sweden, 1935	Exhaustive list (taxes on income and capital).
Finland Germany, 1935	General description ( <i>income and capital</i> ) with <i>gain</i> included; non-exhaustive list.
Hungary Sweden, 1936	General description ( <i>income and capital</i> ) with <i>gain</i> included; non-exhaustive list with <i>taxes on increments</i> excluded on the Swedish side.
France Sweden, 1936	General description ( <i>income and capital</i> ); consultation in case of changes.
Hungary Romania, 1937	General description ( <i>income</i> ); non-exhaustive list.
Germany Romania, 1937	General description ( <i>income</i> ); Non-exhaustive list
France Switzerland, 1937	General description ( <i>income and capital</i> ); non-exhaustive list.
Belgium Germany, 1938	Exhaustive list (income taxes).
Italy Romania, 1938	General description ( <i>income</i> ); exhaustive list.
Denmark Germany, 1938	No express provision on taxes covered, but distributive rules on taxes on income and capital (excluding gains from immovable property); other income provision; property taxes include increment of property.

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*\*The Château de la Muette in Paris has been the headquarters of the OEEC/OECD since 1949.*

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