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Taxes Covered under Article 2 of the OECD Model

The Scope of Tax Treaties in a Dynamic Global Environment of Newly Created Taxes

19

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Taxes Covered under Article 2 of the OECD Model

Why this book?
The material scope of double taxation conventions is the starting point for any application of the agreement, since the understanding of the relevant terms in article 2 of the OECD Model Convention determines whether a treaty is applicable. However, the definition of the material scope of both the OECD Model Convention on Income and on Capital (2017) and the OECD Model Convention on Inheritances, Estates and Gifts (1982) has so far received only little attention in the academic literature.

This book aims to explore the relationship between the OECD Model Conventions 1982 and 2017. Therefore, it analyses crucial areas concerning article 2 of the OECD Model Conventions 1982 and 2017.

The topics include:
- The notion of “tax” according to article 2 of the OECD Model Conventions 1982 and 2017
- The list of taxes according to article 2(3) of the OECD Model Conventions 1982 and 2017
- Identical or substantially similar taxes according to article 2(4) of the OECD Model Conventions 1982 and 2017
- Digital taxes and article 2 of the OECD Model Conventions 1982 and 2017
- Double protection under article 2 of the OECD Model Conventions 1982 and 2017?
- Tax treaty application beyond the scope of article 2 of the OECD Model Conventions 1982 and 2017 (non-discrimination, mutual agreement and mutual assistance)

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Table of Contents

Preface xiii

Chapter 1: The Notion of "Tax" According to Article 2 OECD Model Convention 1982 and 2017 1
Mario Riedl

1.1. Introduction 1

1.2. Characteristics of a tax 4
1.2.1. Compulsory payment 4
1.2.2. Unrequited payment 6
1.2.3. Imposed on behalf of 9
1.2.4. A contracting state or of its political subdivisions or local authorities 12
1.2.5. Irrespective of the manner in which they are levied 17

1.3. Accessory duties or charges to taxes 19

1.4. Ordinary and extraordinary taxes 23

1.5. Conclusion 24

Chapter 2: Taxes on Income According to Article 2(1) and (2) OECD Model Convention 2017 25
Ashrita Prasad Kotha

2.1. Background and drafting history: Article 2(1) and (2) 25
2.1.1. Background 25
2.1.2. "Direct personal or impersonal taxes" to "taxes on income" 26
2.1.3. Rationale for taxes mentioned in article 2(2) 29

2.2. Understanding the substantive scope of "taxes on income" 32
2.2.1. "Taxes on income" as taxes on "total income" or on "elements of income" 32
2.2.2. Autonomous reading of income 33

2.2.3. Specific taxes in article 2(2): Illustrative or exhaustive reference to payroll taxes? 36
2.2.4. Identifying “taxes on income” 39

2.3. Conclusion 40

Chapter 3: Taxes on Capital According to Article 2(1) and (2) OECD Model Convention 2017 45
Christian Knotzer

3.1. Introduction 45

3.2. Taxes on capital in articles 2 and 22 of the OECD Model 50
3.2.1. Taxes on income and capital in article 2(1) and (2) of the OECD Model 50
3.2.2. Taxes on capital in article 22 of the OECD Model 54

3.3. The historical development of taxes on capital in the OECD Model 56
3.3.1. Preliminary remarks 56
3.3.2. League of Nations (1921-1946) 56
3.3.3. OEEC/OECD (1954-2017) 60

3.4. Capital vs property 66
3.4.1. Preliminary remarks 66
3.4.2. The terms capital and property in the system of the OECD Model 68
3.4.3. Is ownership a requirement for a tax to be a tax on capital? 73

3.5. Conclusions 75

Chapter 4: Taxes on Estates and Inheritances and on Gifts According to Article 2(1) and (2) OECD Model Convention 1982 77
Stefanie Gombotz

4.1. The OECD Model Convention on Taxes on Estates and Inheritances and on Gifts 1982 77
4.1.1. General overview and structure of the treaty 77
4.1.2. The principle of duality 79

4.2. Article 2 OECD Model 1982 80
4.2.1. Structure of article 2 80
4.2.2. Article 2(1) and (2) 81

4.3. Notional objective elements in article 2(1) 82
4.3.1. Form of collection of the tax 82
4.3.2. Gratuitousness 84
4.3.3. Periodicity 85

4.4. Taxes on wealth transfers covered by article 2(2) 86
4.4.1. Taxes on estates and inheritances 86
4.4.2. Taxes on wealth transfers inter vivos 88
4.4.3. The issue of trusts and private foundations 89

4.5. Treaty practice 92

4.6. Conclusion 94

Chapter 5: The List of Taxes According to Article 2(3) OECD Model Convention 1982 and 2017 97
Martin Klokar

5.1. Definition and historical background of the list of taxes in the OECD Model Tax Conventions 1982 and 2017 97
5.1.1. OECD Model Tax Convention on Income and on Capital vs OECD Model Tax Convention on Estates and Inheritances and on Gifts 97
5.1.2. Historical evolution of article 2(3) 98

5.2. List of taxes in the OECD Model 2017 102
5.2.1. Non-exhaustive list of taxes 102
5.2.2. The restricting effect of article 2(3) 103
5.2.3. The amplifying effect of article 2(3) 106

5.3. List of taxes in the OECD Model on Estates and Inheritances and on Gifts 1982 107
5.3.1. Exhaustive list of taxes 107
5.3.2. Restricting function of article 2(1) and (2)? 109
5.3.3. Relation of an exhaustive list in article 2(3) and (4) 110

5.4. Alternative formulation of article 2 according to the Commentary to the OECD Model on Income and on Capital 112

5.5. Conclusion 113

Chapter 6: Identical or Substantially Similar Taxes According to Article 2(4) OECD Model Convention 1982 and 2017 115
Josef Schuch and Shimeng Lan

6.1. Introduction 115
6.1.1. Introductory remarks 115
6.1.2. Historical evolvement of the term "substantially similar" 116
6.1.3. Two different routes for a new tax to be covered by the treaty – Interaction with article 2(1) and (2) 118

6.2. The "substantially similar" test – A detailed examination of court decisions 119
6.2.1. Introductory remarks 119
6.2.2. Tax base as the sole criterion to determine "substantially similar" 121
6.2.3. Tax object as the sole criterion to determine "substantially similar" 123
6.2.4. Taxable person combined with tax base and/or tax object 124
6.2.5. Criteria that are combined by the court 125
6.2.6. Lessons learned from the ECJ regarding similar rules in the VAT Directive 128

6.3. The "substantially similar" test – An objective evaluation of the criteria 129
6.3.1. Decisive criteria – Tax base and tax object 129
6.3.2. Relevant criterion – Taxable person 130
6.3.3. Low-relevance criterion – Tax rate 131
6.3.4. Irrelevant criteria 131

6.4. Benchmark for the "substantially similar" test 134
6.4.1. The benchmark for comparison – "Existing taxes" 134
6.4.2. Impact of one contracting state's existing taxes on the other contracting state's tax 134

6.5. The interactions between article 2(4) and other paragraphs of article 2 137
6.5.1. Why is article 2(4) needed? 137
6.5.2. Example of treaties that do not include article 2(1) and (2) 138
6.5.3. Example of treaties that do not include the term "substantially similar tax" under article 2(4) 138
6.5.4. The interaction between article 2(4) and (3) with an exhaustive list – The 1982 OECD Model on Inheritance and Gifts as an example 139

6.6. Conclusion 141

Chapter 7: Diverted Profits Taxes and Article 2 OECD Model Convention 2017 143
Claus Staringer and Martha Caziero

7.1. Introduction 143

7.2. The UK DPT: An overview 144

7.3. The substantive scope of article 2 OECD Model 2017: Which benchmark for testing the DPT? 147
7.3.1. Tax treaties in line with the wording of article 2 OECD Model 2017 147
7.3.2. Tax treaties not in line with the wording of article 2 OECD Model 2017 149
7.3.3. The time of signature of the treaty 150

7.4. DPTs as "subsequent taxes" as per article 2(4) 150
7.4.1. The corporate income tax 151
7.4.2. The DPT 152
7.4.3. Summary of conclusions 158

7.5. DPTs as "existing taxes" as per article 2(3) 160
7.5.1. Article 2 in line with the wording of the OECD Model 2017 160
7.5.2. Article 2 not in line with the wording of article 2 of the OECD Model 2017 161
7.5.3. Any impact from the MLI? 161
7.5.4. Summary of conclusions 162

7.6. Conclusions 163

7.7. The coverage of DPT under article 2: A theoretical problem or relevant in practice? 164

Chapter 8: Digital Taxes and Article 2 OECD Model Convention 2017 167
Pasquale Pistone and Andreas Ullmann

8.1. What is a digital tax? 167
8.1.1. Introduction 167
8.1.2. Digital taxes around the globe 169

8.2. The European DST as an example 174
8.2.1. Background and legislative intent 174
8.2.2. Structure 176

8.3. DST and the objective scope of DTCs 180
8.3.1. Article 2 OECD Model 2017 180
8.3.2. DST: A tax on income or on capital? 185
8.3.3. An identical or substantially similar tax? 192

8.4. DST and relief for double taxation 195
8.4.1. Relief provided by DTCs 195
8.4.2. Other relief 197

8.5. Conclusion and outlook 199

Chapter 9: Industry-Specific Taxes and Article 2 OECD Model Convention 1982 and 2017 201
Cristóbal Pérez Jarpa

9.1. Introduction 201

9.2. Essentials of article 2 OECD Model 1982 and 2017 203
9.2.1. Article 2: Taxes covered 203
9.2.2. Terms: Taxes on income and on capital and EIG taxes 205
9.2.3. Tests application 212

9.3. Specific taxes in the extractive industry 213
9.3.1. The extractive industry and its specific taxes 213
9.3.2. Production sharing payments within PSCs 215
9.3.3. Testing production sharing payments and their coverage under article 2 OECD Models 217

9.4. Specific taxes in the financial industry 223
9.4.1. The financial industry and its specific taxes 223
9.4.2. Bank levies and their coverage under article 2 OECD Models 224
9.4.3. FATs and their coverage under article 2 OECD Models 229
9.4.4. FTTs and their coverage under article 2 OECD Models 233

9.5. Conclusions 236

Chapter 10: Double Protection under Article 2 OECD Model Convention 1982 and 2017? 239
Markus Mittendorfer

10.1. The OECD Model 1982 and 2017 239

10.2. Article 2(1) and (2) OECD Model 1982 and 2017 241
10.2.1. The general definition in article 2(1) and (2) OECD Models 241
10.2.2. The relation between the two model conventions 246
10.2.3. Delimitation between taxes on income and on capital and taxes on estates, inheritances and gifts 248

10.3. The importance of article 2(3) and (4) OECD Models 1982 and 2017 252
10.3.1. The list of taxes according to article 2(3) OECD Models 252
10.3.2. The amplifying power of article 2(3) OECD Models 255
10.3.3. The relation between the two model conventions 258

10.4. Conclusion and outlook 259

Chapter 11: Tax Treaty Application beyond the Scope of Article 2 OECD Model Convention 1982 and 2017 (Mutual Agreement, Non-Discrimination, Mutual Assistance) 263
Alexander Rust, Gabriela Capristano and Xiangdan Luo

11.1. Introduction 263

11.2. MAP beyond the substantive scope of the OECD Models 1982 and 2017 265
11.2.1. The MAP beyond the scope of the convention 265
11.2.2. Meaning of double taxation 266
11.2.3. Meaning of "not provided for in the Convention" 268

11.3. Mutual assistance clauses under the OECD Model 2017 273
11.3.1. Commonality, relationship and subject of the mutual assistance clauses 273
11.3.2. Article 26 of the OECD Model 2017 275
11.3.3. Article 27 of the OECD Model 2017 281

11.4. Non-discrimination clauses 283
11.4.1. Relationship between article 10 OECD Model 1982 and article 24 OECD Model 2017 283
11.4.2. Article 24(6) of the OECD Model 2017 284
11.4.3. Article 10(4) of the OECD Model 1982 286

11.5. Conclusion 286

List of Contributors 289

Preface

So far, relatively little research has focused on the material scopes of the OECD Model Conventions 1982 and 2017. In particular, the relationship between the two OECD Model Conventions remains unclear. In order to analyse important issues concerning this relationship, the 27th Viennese Symposium on International Tax Law was held on 15 June 2020. Given the current situation regarding COVID-19, the symposium was held online as well as physically at WU (Vienna University of Economics and Business). Renowned professors from Austrian and foreign universities, tax researchers from WU and tax experts from various countries participated in the symposium. The speakers have since completed papers using input received during the symposium and these papers have become the chapters of this book. Each author offers an in-depth analysis along with the most recent scientific research on their topic.

The editors would like to thank Renée Pestuka, Hedwig Pfanner and Markus Mittendorfer who were the main persons responsible for the organization of the symposium and made essential contributions to the preparation and publication of this book. The editors would also like to thank all of the authors who have patiently revised their contributions in order to enhance the quality of the book, and Jenny Hill, who contributed greatly with her linguistic editing of the authors' texts.

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Chapter 7

Diverted Profits Taxes and Article 2 OECD Model Convention 2017

Claus Staringer and Martha Caziero

7.1. Introduction

Diverted profits taxes (DPTs) are anti-avoidance rules created to prevent the diversion of profits offshore and the avoidance of a taxable presence in the relevant country through contrived arrangements.

The United Kingdom, followed by Australia,[1] famously introduced a DPT in its tax system in 2015. Since then, the question of its coverage by double tax conventions has been of great academic and political interest because, if answered in the positive, there would be an obvious risk of treaty override.[2] The existence, extent and admissibility of any treaty override, however, are out the scope of this chapter since the authors will only focus on the coverage of DPTs under article 2 of the OECD Model (2017).[3]

The authors argue that DPTs are covered by double tax conventions in case they are "subsequent taxes", which means that they are introduced after the date of signature of the tax treaty. As DPTs are a rather new instrument in the toolbox of domestic legislators, such post-treaty introduction will be the most frequent case. The standard used to arrive at this conclusion is the "substantial similarity test" set forth by article 2(4), and it entails a comparison between the tested tax and another of the taxes explicitly covered by the treaty. In the case of the DPT, the authors compare the latter with the corporate income tax that is typically included in the list of taxes

1. H.K. (J.) Nguyen, *Australia's New Diverted Profits Tax: The Rationale, the Expectations and the Unknowns*, 71 Bull. Intl. Taxn. 9 (2017), Journal Articles & Papers IBFD.
2. R. Tomazela Santos, *The United Kingdom's Diverted Profits Tax and Tax Treaties: An Evaluation*, 70 Bull. Intl. Taxn. 7, sec. 4. (2016), Journal Articles & Papers IBFD; D. Neidle, *The diverted profits tax: flawed by design?*, British Tax Review 2, 2015, pp. 147-166; P. Baker, *Diverted profits tax: a partial response*, British Tax Review 2, 2015, pp. 167-171; R. Ismer & C. Jescheck, *The Substantive Scope of Tax Treaties in a Post-BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes*, 45 Intertax 5, 2017; S. MacLennan, *The Questionable Legality of the Diverted Profits Tax Under Double Taxation Conventions and European Union Law*, 44 Intertax 12, 2016.
3. *OECD Model Tax Convention on Income and on Capital: Condensed Version 2017*, art. 2 (21 Nov. 2017), Treaties & Models IBFD.

that are covered. To the contrary, if new tax treaties are signed at a time when the DPT is already part of the domestic tax system of one or both of the contracting states, it will be considered as an "existing tax". Because of its qualification as an "existing tax", the outcome of the analysis varies depending on whether article 2 of the relevant treaty follows the wording of the OECD Model (2017). If it does and, as a result, contains the general definitions of article 2(1) and (2) and a non-exhaustive list of taxes covered in paragraph 3, then there is room for arguing that the DPT is a tax on income as per the general definitions. If, to the contrary, the list of article 2(3) is exhaustive, its limiting effect will result in the DPT being excluded from the scope of the treaty.

In order to reach these conclusions, the authors will, first, give a brief explanation of how the DPTs function by taking the UK DPT as an example (due to its prototype nature for other countries' DPTs); second, carry out a reconstruction of article 2 of the OECD Model (2017) to set the benchmark of their analysis; third, analyse the reasons why the DPT as "subsequent tax" falls within the definition of "substantially similar tax"; and fourth, analyse the reasons why the DPT as an "existing tax" can or cannot be considered as being part of the list of taxes covered by article 2 depending on whether the list of taxes covered is exhaustive.

7.2. The UK DPT: An overview

The United Kingdom has introduced a DPT that tackles (i) the involvement of entities or transactions lacking economic substance and (ii) the avoidance of permanent establishment (PE) status in the United Kingdom.[4]

The taxable persons are, respectively, UK-resident companies (and PEs) that do not qualify as small or medium-sized enterprises (SMEs)[5] and non-resident companies above a certain threshold of sales and expenses in the United Kingdom.[6]

---

4. *See* UK: the Finance Act 2015, Part 3 [hereinafter FA 2015]; *see also* Her Majesty's Revenue and Customs (HMRC) Diverted Profits Tax Guidance of 30 Nov. 2015, p. 1, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/768204/Diverted_Profits_Tax_-_Guidance__December_2018_.pdf (accessed 22 Dec. 2020).
5. Sec. 80(1)(g) FA 2015, Part 3.
6. According to sec. 87 FA 2015, Part 3, the sec. 86 charge will not apply if the UK-related sales revenues do not exceed GBP 10 million and, alternatively or cumulatively, the UK-related expenses do not exceed GBP 1 million.

The situations in which the DPT applies are essentially two. The first occurs whenever entities with a UK taxable presence (including already existing PEs in the United Kingdom) are involved in artificial transactions with related parties through which there is an increase in the tax liability abroad of less than 80% of the reduced tax liability in the United Kingdom. The example provided by the HMRC Guidelines is a structure in which a UK-resident company needs to invest in plants and machinery and, instead of directly acquiring them, enters into an operating lease with a sister company located in a low-tax jurisdiction. The royalty payments from the UK-resident company reduce its taxable base and are not taxed in the country of residence of the sister company. Were there not tax motives, the HMRC argues that the UK-resident company would have acquired the plants and machinery itself.[7]

The second scenario occurs whenever non-resident companies that sell goods or services in the United Kingdom, with the support of a local enterprise, design their activity in a way so that they avoid having a PE there. One of the examples provided by the HMRC Guidelines is an avoided dependent PE structure for which the deemed PE is a UK-resident company performing, on paper, marketing and customer support services only and is remunerated by its non-resident parent with a modest margin. The arrangements between the two companies are designed in a way that the deemed PE does not sign any contract despite having staff with substantial ties and negotiation power with UK customers.[8]

In the first scenario (the artificial transaction), the taxable base is calculated by comparing the actual transaction carried out and the so-called "relevant alternative provision". This provision is the transaction that would have been carried out were it not for tax reasons, i.e. a transaction that is in line with economic reality.

7. HMRC Diverted Profits Tax Guidance of 30 Nov. 2015, *supra* n. 4, at p. 34.
8. In the example provided by the HMRC, the parent company with a deemed UK PE is resident in a Member State of the European Union and has a negligible taxable base in its country of residence because it pays a high amount of royalties to an associated enterprise located in another EU Member State. This latter company, in turn, sub-licenses the IP rights to which such royalty payments are linked from another associated company located in a low-tax jurisdiction. The first royalty payment is exempt from withholding tax due to a favourable tax treaty between the two EU countries. The second royalty payment is also exempt from withholding tax because the domestic law of the intermediary company's country of residence does not levy any withholding tax on outbound royalty payments. The result is that the flow of royalties is never taxed. Therefore, according to the HMRC, both the mismatch condition and the effective tax mismatch condition would be met. *See* example in HMRC Diverted Profits Tax Guidance, *supra* n. 4, at p. 40, n. 3.

This comparison can lead to three outcomes:

(i) In the first case, the actual transaction is in line with economic reality and the transfer price is at arm's length. More in detail, this means that both transactions lead to (i) the same kind (i.e. same type and for the same purpose) of reductions for the first party and non-increase of taxable income in the tax base of the associated party and to (ii) the same pricing.[9] In this case, there is simply no DPT liability.

(ii) In the second case, the actual transaction is, as such, in line with economic reality, but the transfer price is not at arm's length. More specifically, the comparison results in the same kind of reductions and no corresponding increase of taxable income for the associated party but different pricing. Here, the taxable base is the difference between the arm's length price of the transaction and the actual price set by the affiliated parties.

(iii) In the third case, the actual transaction in not in line with economic reality altogether. In other words, the relevant alternative provision would not have led to the same kind of deductions and/or would have led to a corresponding increase of taxable income in the tax base of the associated party. Here, after the recharacterization of the transaction, the taxable base is the price that would have been set in the recharacterized transaction under ordinary market conditions. The first scenario's structure described above is an example of this. If it were not for tax reasons, the UK-resident company would have acquired the plants and machinery instead of leasing them from a related party that does not add any value in the supply chain. After recharacterizing the transaction into an acquisition of plants and machinery on behalf of the UK-resident company, the taxable base for the DPT would be the difference between the deduction that followed the actual transaction and the deduction that would have been allowed if the UK-resident company would have carried out the transaction in line with economic reality.

In the second scenario (the avoided PE), the taxable base is the "notional PE profits" which are the profits that would have been taxable in the United Kingdom had the foreign company reported the existence of a PE there.[10]

9. This also holds true in the case that the taxpayer carried out an adjustment to its taxable base in its corporate tax return before the end of the review period.
10. Plus, the expenses borne by the foreign company when they aimed at circumventing the obligation to withhold taxes in the United Kingdom.

Therefore, reference is made to the ordinary corporate income tax rules for the determination of taxable profits of PEs of foreign companies.[11]

In the second scenario's example above, the non-resident company would be taxed in the United Kingdom on the profits attributable to its (deemed) agent PE which, despite substantially performing the conclusion of contracts there, was remunerated only for its marketing and customers support services.

Finally, the tax rate is 25%,[12] which is 6% more than the ordinary corporate income tax rate.

7.3. The substantive scope of article 2 OECD Model 2017: Which benchmark for testing the DPT?

The analysis of the coverage of the DPT under article 2 takes different benchmarks depending on two variables. The first one is whether the relevant tax treaty follows the wording of the OECD Model (2017). The second is whether the DPT is a "subsequent tax" or an "existing tax" with respect to the date of signature of the tax treaty.

7.3.1. Tax treaties in line with the wording of article 2 OECD Model 2017

If the contracting states follow the wording of the OECD Model (2017), article 2 of their tax treaty will be structured and interpreted as explained in the following paragraphs.

The general definitions of article 2(1) and (2) specify that the treaty covers taxes on income or elements of income.[13] While the Commentary on Article 2(2) further states that taxes on profits are included,[14] certain authors have considered it "obvious" that corporate tax is covered as it is levied on

11. Sec. 88(5)(a) FA 2015.
12. However, according to sec. 79 FA 2015, when taxable diverted profits are ring-fenced profits or notional ring-fenced profits in the oil sector, DPT is charged at a rate of 55% plus true-up interest.
13. Para. 2 *OECD Model: Commentary on Article 2* (2017).
14. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 2*, para. 2 (21 Nov. 2017).

income of corporations.[15] Corporate income tax, however, is also usually listed in the list of taxes "in particular" covered by article 2(3). In accordance with the OECD Model (2017), article 2(3) is a non-exhaustive list of taxes included in the double tax treaty with amplifying power. Because of its non-exhaustive nature, a tax that is not listed in article 2(3) but falls within the scope of the general definitions provided by article 2(1) and (2) is in any case covered by the treaty. Because of its amplifying power, if a tax that does not fall within the general definition of "tax on income" is explicitly included in the list of article 2(3), it will be covered by the double tax treaty.[16]

Finally, article 2(4) expands the scope of the treaty to future (*rectius*: subsequent) identical or "substantially similar" taxes to those covered by article 2. Here, the most interesting debate concerns the benchmark of such a substantial similarity test: is it the general definitions or the list of taxes covered? Scholars have put forward valuable arguments on both sides,[17] but the authors side with the view that the benchmark should be the list of taxes of article 2(3). The reason is that the general definitions of article 2(1) and (2) apply without any time limitation,[18] so that, if the benchmark for the substantial similarity test were the general definitions, the very existence of article 2(4) would be useless as the general definitions would apply with or without article 2(4). As a result, taxes introduced after the signature of the treaty that are not substantially similar to those listed in article 2(3) would be covered in any case if they qualify as "taxes on income" as per article 2(1) and (2).

For the purposes of this analysis, however, this debate is of minor importance for two reasons. The first one is that there is little doubt that corporate income tax is a tax on income as per the general definitions as it is a tax

15. R. Ismer & A. Blank, *Art. 2*, in *Klaus Vogel on Double Taxation Conventions*, m.no. 34 (E. Reimer & A. Rust eds., 4th edn, Kluwer Law International 2015).
16. This is the position taken by Working Party No. 30 of the OECD Fiscal Committee (Austria-Switzerland), received on 12 June 1969, FC/WP 30 (69).
17. The OECD Working Party 30 takes the view that the ordinary benchmark for art. 2(4) is given by the general definitions of art. (1) and (2), m.no. 12. Similarly, Tenore argues that due to the declaratory nature of the list of art. 2(3), the benchmark for assessing similarity under art. 2(4) must necessarily be art. 2(1) and (2). Eventually, a new tax introduced after the date of signature of a tax treaty can be covered by the DTC if it falls within the scope of the general definitions of art. 2(1) and (2) regardless of whether it replaces an existing tax mentioned in the list of art. 2(3). *See* M. Tenore, *"Taxes Covered": The OECD Model (2010) versus EU Directives*, 66 Bull. Intl. Taxn. 6, sec. 2.4. (2012), Journal Articles & Papers IBFD. To the contrary, Lang argues that the benchmark should be given by Article 2(3), *see* M. Lang, *"Taxes Covered" – What is a "Tax" according to Article 2 of the OECD Model?*, 59 Bull. Intl. Taxn. 6, sec. 4.1. (2005), Journal Articles & Papers IBFD.
18. Ismer & Blank, *supra* n. 15, at m.no. 60.

on profits.[19] The second reason is that corporate income tax is typically in the list of taxes covered by article 2. Therefore, if corporate income tax is a "tax on income" in the sense of the general definitions and is always in the list of taxes covered, it is more efficient to perform the "substantial similarity" test by taking the corporate income tax as benchmark. In other words, if the DPT is "substantially similar" to the corporate income tax, and the corporate income tax is a "tax on income", then the DPT will also be similar to an "income tax" in the sense of article 2(1) and (2). As a result, this analysis would be of use for any treaty regardless of the inclusion of general definitions and whatever side in the debate concerning the benchmark of article 2(4) is taken.

7.3.2. Tax treaties not in line with the wording of article 2 OECD Model 2017

If the contracting states do not follow the wording of the OECD Model (2017), the above interpretation of article 2 does not hold true, as it is difficult to contend that the treaty negotiators intended to give the treaty an OECD-compliant interpretation if they deviated from it.

One of the most common deviations from the OECD Model (2017) is the lack of the general definitions of article 2(1) and (2) and an exhaustive list of taxes covered under article 2(3).[20] For the OECD Working Party No. 30, the lack of general definitions limits the "substantial similarity" to the list of taxes covered as they take the position that, when the treaty follows the ordinary wording of the OECD Model, the benchmark for assessing similarity are the general definitions.[21] However, since the authors argue that the general definitions are not the benchmark for assessing the similarity of future taxes, the lack of article 2(1) and (2) would only restrict the coverage of future taxes to those taxes that are similar to the ones explicitly listed.

The exhaustive nature of the list of taxes covered renders the interpretation of article 2(3) completely different from the one given above as it cannot be claimed that treaty negotiators omit the inclusion of some "existing taxes" without any reason. To the contrary, it seems logical that the reason to exclude an "existing tax" from the list of taxes covered is indeed to exclude that tax from the tax treaty coverage.

19. Para. 2 *OECD Model: Commentary on Article 2* (2017).
20. Para. 6.1 *OECD Model: Commentary on Article 2* (2017).
21. Working Party No. 30 of the OECD Fiscal Committee (Austria-Switzerland), received on 12 June 1969, FC/WP 30 (69), para. 12.

The lack of general definitions and the inclusion of an exhaustive list of taxes covered is normally coupled with the inclusion of article 2(4).[22] Therefore, the scope of the exhaustive list would expand to future taxes whenever they are "substantially similar" to the ones listed.

7.3.3. The time of signature of the treaty

This analysis served the purpose to set the benchmark for assessing the tax treaty coverage of the DPT. If the DPT is a "subsequent tax" (i.e. a tax introduced after the signature of a tax treaty), the applicable paragraphs are potentially article 2(1) and (2) and article 2(4). However, since the corporate income tax also qualifies as a "tax on income" in the sense of the general definitions, the authors would argue that article 2(4) is the better benchmark. Besides the pragmatic reason that it is always included in the list of taxes covered, comparing the DPT with the corporate income tax also renders this analysis useful whatever treaty policy is followed. It is, in fact, valid regardless of whether the treaty under scrutiny includes or not the general definitions and a (non) exhaustive list of taxes covered.

To the contrary, if the DPT is an "existing tax" (i.e. already existing at the time of signature of the tax treaty but not listed), the analysis dramatically changes depending on whether the contracting states follow the OECD Model (2017).

If they do, there is some room to claim that since the list is not exhaustive, taxes that qualify as "income taxes" are covered. If they do not follow the OECD Model, the exhaustive nature of the list prevents from arguing that an existing tax that was not included in the list was actually meant to be covered regardless of the presence of general definitions.

7.4. DPTs as "subsequent taxes" as per article 2(4)

The DPT has the purpose of subjecting to tax profits shifted to low-tax jurisdictions through arrangements not in line with normal commercial practice.

To put it simply, the DPT protects the United Kingdom's taxing rights on corporate income by discouraging shifting of income when it is driven by tax reasons.

22. Para. 6.1 *OECD Model: Commentary on Article 2* (2017).

To assess "substantial similarity" under article 2(4), two approaches might be followed: the "micro-approach" that prescribes assessing similarity of new taxes by comparing them with each single tax that is mentioned in the list; and the "macro-approach" that stipulates comparing the new taxes with a combination of several taxes listed.[23]

Since this analysis does not concern one specific tax treaty but rather the OECD Model (2017), the authors will follow the "micro-approach", assuming that the corporate income tax is always present in the list of taxes covered. Therefore, it is necessary to look at the core elements of the new tax, i.e. subject, object, purpose and calculation of the tax base, with the last one being the most important element,[24] and compare them with the relevant benchmark. It seems logical to contend that the relevant benchmark should be the UK corporate income tax[25] for the DPT applies on corporate profits shifted abroad.

7.4.1. The corporate income tax

The UK corporate tax system taxes UK-resident companies on their worldwide income and taxes non-UK resident companies on their profits generated in the United Kingdom. It is a schedular system for which total profits are the aggregate of net income deriving from each source and net chargeable gains arising from the sale of capital assets. For some of the sources of income, the starting point is the accounts results with some adjustments. The rules for calculating deductions also differ according to the specific source.[26]

For carrying out the substantial similarity test, it is fundamental to break down the features of the corporate income tax into (i) purpose, (ii) subjects, (iii) object, (iv) calculation of the tax base and (v) tax rate.

23. Ismer & Blank, *supra* n. 15, at m.no. 64.
24. Tomazela Santos, *supra* n. 2, at p. 400, sec. 2.; Ismer & Jescheck, *supra* n. 2, at pp. 386-387, sec. 3.1.
25. In accordance with para. 8 of the OECD Commentary on Article 2(4) of the OECD Model (2017), the convention applies also to taxes that are imposed after the signature of a treaty *in a contracting state* in addition to or in place of an existing tax *in that state*. Therefore, it seems that according to the Commentary, the substantial similarity test should be performed only within one country's list of taxes. *Contra*, Lang, *supra* n. 17, at sec. 4.1.
26. S. Adam, J. Browne & C. Heady, *Taxation in the UK*, in *Dimensions of Tax Design: The Mirrlees Review* pp. 1-77 (S. Adam et al. eds., Institute for Fiscal Studies (IFS), Oxford University Press 2010).

Purpose: A traditional justification for corporate income taxation is to consider it a surrogate taxation of the shareholders. If the corporate profits as personal savings are considered, the corporate income tax applies on such personal savings as they accrue so that it works as a withholding tax on the return on equity capital. The reason for having it, therefore, is that it is administratively convenient for taxing the shareholders.[27]

Subjects: Corporate income tax applies on every UK-resident company and PEs of foreign companies in the United Kingdom.

Object: The sources of taxable income for corporations are (i) profits of trade, (ii) profits of a property business, (iii) non-trading profits from loan relationships, (iv) non-trading gains on intangible assets and (v) non-exempt dividends or other company distributions. Capital gains arising from the disposal of capital assets are also subject to corporate tax.

Calculation of the tax base: The UK system is a schedular system but, for the categories of income (i) to (iv) above, the calculation of the tax base starts from the accounting results and later amended in accordance with the relevant tax rules on deduction. There are also category-specific rules for depreciation (so-called capital allowances).

Tax rate: The general tax rate is 19%.

7.4.2. The DPT

The DPT applies whenever the relevant taxpayer artificially (i.e. by means that do not reflect economic reality because they are essentially driven by tax reasons) diverts its profits to a low-tax jurisdiction where the increased tax liability is less than 80% of the tax saving in the United Kingdom. In the case of artificial transactions, the consequence is (i) either a recharacterization of facts and/or (ii) a transfer pricing adjustment. In the case of the omitted PE, the DPT makes a PE exist for UK tax purposes and taxes it in accordance with the ordinary profit allocation rules.

27. M. Gammie, *Taxing corporate profits in a Global Economy*, [2013] British Tax Review 1.

Thus, the DPT brings back into the radar of the domestic taxing rights situations that had being shifted abroad for tax avoidance reasons. It goes even further by subjecting the "diverted profits" to a punitive tax rate of 25% (6% more than the ordinary rate).

The *purpose* of the DPT is therefore twofold: to protect domestic taxing rights and to discourage profit shifting. Countries are, in principle, free to exercise their taxing powers on any item of income of any (potential) taxpayer.[28] There is no principle in international law that prohibits a state from levying a tax on a national or a resident of another state.[29] Nonetheless, most countries decided to limit their own tax sovereignty through the adoption of double tax treaties[30] built on the concepts of residence[31] and source.[32] In

28. The issue of whether tax treaties have created customary international law is controversial. In support of the view that they do, *see* R.S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press 2007); contra, H.D. Rosenbloom, *Cross-Border Arbitrage: The Good, the Bad and the Ugly*, 85 Taxes - The Tax Magazine 3 (March 2007), pp. 115-118. The present authors side with the view that there is no sufficient state practice and *opinio juris* on territorial taxation, as per art. 38 Statute of the International Court of Justice. Avi-Yonah, id., provided an example for that. Looking at the design of the rule on "foreign personal holding corporation" introduced in the United States in 1937, he argues that prohibition on extra-territorial taxation was initially considered as a customary rule which then changed due to a widespread introduction of CFC rules. However, whether or not such prohibition was perceived as legally binding by a sufficient number of states, it can be reasonably affirmed that this is no longer the case. The consequence of that is that states are bound to residence- (or citizenship) based and territorial taxation only by tax treaties and not by customary international law.

29. H. Wurzel, *Foreign Investment and Extraterritorial Taxation*, 38 Columbia Law Review 5 (1938), pp. 809-857. *JSTOR*, www.jstor.org/stable/1116739 (accessed 28 July 2020). Here, the author refers to Kelsen when affirming that the real limit to an unrestricted tax jurisdiction is the impossibility of exercising coercive powers on sanctions in another jurisdiction without the intervention of local authorities. However, there is a debate in the academic world stemming from different interpretations of the PCIJ's famous *Lotus* judgment. Among those who claim that in principle international law does not pose any limit to states' jurisdiction, *see* M. Norr, *International Tax and International Income*, 17 Tax L. Rev., p. 431 (1961-1962); A. A. Knechtle, *Basic Problems in International Fiscal Law*, p. 34 (Kluwer 1979); *contra* S. Gadzo, *The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal,* 46 Intertax 3, pp. 194-209 (2018); J. Kokott, '*The "Genuine Link" Requirement for Source Taxation in Public International Law*', in *Tax and the Digital Economy* ch. 2, p. 9 et seq. (W. Haslehner et al. eds, Kluwer 2019).

30. C.E. McLure, Jr., *Globalization, Tax Rules and National Sovereignty*, 55 Bull. Intl. Taxn. 8, sec. II.B. (2001), Journal Articles & Papers IBFD.

31. Arguing that residence is not intrinsically linked to taxation, *see* W. Cui, *Minimalism about Residence and Source*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2677429 (accessed 22 Dec. 2020).

32. For a critical appraisal of such principles in the international tax framework, *see* M. Devereux & R. de la Feria, *Designing and implementing a destination-based corporate*

other words, by entering into double tax treaties, countries decided to confine the exercise of their taxing powers to the existence of some grounds of jurisdiction, i.e. to subject tax sovereignty to the existence of a link between the territory and either the taxable person (residence or citizenship) or the taxable item of income (source).

The structure of the DPT reveals a retreat from such voluntary limitation of taxing powers (achieved through the principles of residence and source) and, therefore, a re-extension of sovereign powers to so-called "extra-territorial" instances. The United Kingdom – taken here as a real-life example of a country that adopted a DPT – evidently perceives the rules set in double tax treaties as potentially prohibiting an extra-territorial tax. As a result, it designed the DPT as a tax that protects the country from the risk of base erosion caused by artificial circumventions of the principles of residence and source, however, not by giving up these principles at large but only in specific circumstances. Without getting into the discussion of whether or not DPTs are compatible with the treaties, it suffices here to say that the UK DPT's design suggests that the legislator's intention was to design a tax that is extra-territorial only prima facie. It might be said, in fact, that the DPT actually aims at enforcing that voluntary limitation of tax sovereignty achieved through the tax treaties,[33] but only to the extent that the factual circumstances under which such sovereignty is given up are not such as to reveal an artificial circumvention of the commonly agreed principles of residence and source.

Against this background, tackling profit shifting is the practical second and most important purpose of the DPT, and there might be several reasons behind it. The first, rather obvious one, is a budgetary reason achieved through direct revenues and revenues from increased compliance with corporation tax rules.[34] Simply put, a state needs to finance itself and, if corporate profits are diverted, corporate income tax revenues decrease and less

tax, Oxford University Centre for Business Taxation WP 14/07 (May 2014), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3481360&download=yes (accessed 22 Dec. 2020).

33. The OECD Interim Report 2018 notices that since the DPTs work as a deterrent complementary to the existing anti-abuse rules in the income taxation area, they are built on the existing international standards of nexus and profit attribution. *See* OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing 2018, p. 147.

34. The OECD Interim Report 2018 reports that the United Kingdom's revenue from the collection of DPT amounts to EUR 330 million in 2016/17, including additional amounts of corporate income tax raised as a consequence of behavioural changes; *see* OECD, *Tax Challenges Arising from Digitalisation*, id., at p. 151.

mobile factors of production (e.g. labour, property, consumption) suffer a heavier burden of taxation to compensate the loss of corporate income tax revenues.[35] The second reason is to achieve neutrality. All residents are treated equally if no resident company takes advantage of mispricing the transactions it enters into with associated companies located in low-tax jurisdictions (i.e. realization of capital export neutrality through enforcement of anti-base erosion and profit shifting (BEPS) measures). Also, all the companies that benefit from the economic infrastructures[36] provided by a country are subject to tax in the same way, including those non-residents that, despite taking advantage of such an infrastructure, design their activity so as not to have a dependent agent PE.

No matter how convincing this reasoning might be, however, it is still incomplete. It answers the question of why a country might need to protect its taxing jurisdiction's boundaries, but it does not answer why it does so by taxing corporate profits.

The answer cannot be successfully found if one limits itself to look into the framework of the DPT only. It is necessary to look back at the corporate tax system to find out that its rationale is to surrogate shareholders' taxation at the time when their personal savings accrue.

Therefore, even if, at first look, it seems that the purpose of the DPT is somehow disconnected from the purpose of corporate income tax, as it protects only the geographical boundaries of a country's tax jurisdiction, the authors argue that they share the same goal.

Controlled foreign company (CFC) rules are another example of this.[37] Even though they provide for taxation of a certain country's resident companies, thereby in compliance with the residence principle, de facto they tax the non-resident's income on a look-through basis.[38] Again, the point here is

35. The OECD considers it as one of the detrimental effects caused by the profit-shifting phenomenon due to the existence of harmful preferential tax regimes on mobile activities; *see* OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing 1998, available at https://doi.org/10.1787/9789264162945-en, para. 30 (accessed 22 Dec. 2020).
36. On the benefits principle as the underlying principle of the division of taxing rights, *see* Avi-Yonah, *supra* n. 28, at p. 11.
37. Avi-Yonah, id., at pp. 24-27. Here, the author affirms, inter alia, that the first version of the CFC rules in the United States assumed a deemed dividend distribution from the non-resident subsidiary to the resident company because direct taxation of a non-resident on foreign income would have been considered an extra-territorial act in breach of international law.
38. Avi-Yonah, *supra* n. 28, at p. 25.

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