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Editors: Georg Kofler, Michael Lang, Pasquale Pistone, Alexander Rust, Josef Schuch, Karoline Spies, Claus Staringer

Exemption Method and Credit Method

The Application of Article 23 of the OECD Model

24

European and International Tax Law and Policy Series

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Exemption Method and Credit Method

Why this book?
The method article of any tax treaty plays an essential role in avoiding juridical double taxation. It determines the extent to which the residence state refrains from taxing an item of income if both contracting states may tax according to the distributive rules of the treaty. Calculating the respective relief can be challenging, as the wording of both articles 23A and 23B of the OECD Model leaves significant room for interpretation. In the European Union, such interpretation is made even more difficult because the application of the method article needs to comply with EU law, in particular with the fundamental freedoms and the State aid rules. Finally, the method article of the OECD Model has – in the aftermath of the Base Erosion and Profit Shifting Project – undergone adaptations, the impact of which requires further analysis.

This book aims to provide an in-depth analysis of all the current issues related to the application of articles 23A and 23B of the OECD Model. The topics discussed include:

- the method article and unilateral measures to avoid double taxation;
- the method article and allocation conflicts;
- conflicts of qualification under articles 23A(1) and 23B(1) of the OECD Model;
- the credit method and different taxes on income and on capital;
- the exemption method with proviso safeguarding progression; and
- relief from double taxation and EU State aid law

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Visitors' address:
Rietlandpark 301
1019 DW Amsterdam
The Netherlands

Postal address:
P.O. Box 20237
1000 HE Amsterdam
The Netherlands

Telephone: 31-20-554 0100
Email: info@ibfd.org
www.ibfd.org

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Preface

If the application of the distributive rules of a tax treaty following the OECD Model Tax Convention (OECD Model) does not suffice to avoid juridical double taxation, the method article of the treaty requires the residence state to provide relief. To what extent such relief is granted chiefly depends on the method applied by the residence state to that effect. Articles 23A and 23B of the OECD Model include the two most prominent methods to avoid juridical double taxation: the exemption with progression method and the ordinary credit method. Since the wording of both articles is rather broad, the calculation of the relief requires a comprehensive interpretation of the method article in light of the rest of the treaty and, in some respects, also a recourse to the domestic law of the residence state.

So far, little research has focused on the details of the calculation of double taxation relief according to articles 23A and 23B of the OECD Model. In addition, the impact of the changes to the wording of both articles in the course of the 2017 OECD Model update following the Base Erosion and Profit Shifting Project combined with the changes to the Commentary on the OECD Model requires a closer scientific examination.

In order to address these matters alongside other important and current issues related to the application of article 23 of the OECD Model, the 28th Viennese Symposium on International Tax Law was held on 14 June 2021. Given the current situation regarding COVID-19, the symposium was held physically at WU (Vienna University of Economics and Business) as well as online. 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 Hedwig Pfanner, Karina Hertle and Nicholas Pacher, who were the main people responsible for the organization of the symposium and who 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 Dr Julienne Stewart-Sandgren, who contributed greatly with her linguistic editing of the authors' texts.

Above all, our sincere thanks goes to the publishing house at IBFD for agreeing to include this publication in its catalogue.

Georg Kofler
Michael Lang
Pasquale Pistone
Alexander Rust
Josef Schuch
Karoline Spies
Claus Staringer

Chapter 1

Method Article and Unilateral Measures to Avoid Double Taxation

Alexander Rust and Joy Waruguru Ndubai

1.1. Introduction

In order to eliminate double taxation, countries may adopt unilateral and bilateral/multilateral approaches. Through the unilateral approach, a jurisdiction will provide the preferred method(s) and rules of application or procedural requirements. In comparison, the bilateral approach will be based upon the provisions of a tax treaty, which will generally provide distributive rules to determine the jurisdiction with the primary taxing right, and, when no determination is made or both states have a right to tax, article 23 will identify the preferred method(s) of each contracting state for the avoidance of double taxation. In addition, tax treaties will only cover specific taxes on income and on capital and will not provide administrative rules on the operation of the selected method of eliminating double taxation. This means that "few rules of application are provided for in the treaties themselves" and, "for the most part, tax treaties leave the method for the application of the provisions of the treaties up to the domestic law of the contracting states".[1] For this reason, the functioning of a treaty and, in turn, the method article cannot be separated from the domestic tax laws of the resident jurisdiction tasked with elimination. It is, therefore, important to understand the relationship between the provisions of domestic law and the applicable tax treaty.

Although tax treaties have a long-established history,[2] nearly all countries have had unilateral measures available for taxpayers to access relief. This often means that unilateral measures, to avoid double taxation, will have

1. A. Trepelkov, H. Tonino & D. Halka (eds.), *UN Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* p. 2 (United Nations 2013).
2. The first modern treaty for the prevention of double taxation of income was concluded between Prussia and Saxony on 16 April 1869. The negotiation of similar treaties grew after World War I, following the introduction of income taxes amongst European countries. Subsequent work by the League of Nations starting in 1921 set the stage for Model Conventions as they are known today. *See further* A. Easson, *Do we still need Tax Treaties,* 54 Bull. Intl. Taxn. 12 (2000), Journal Articles & Opinion Pieces IBFD.

been well developed. Consequently, this has raised questions amongst a number of academics about the relevance of tax treaties, which will be briefly addressed in this chapter. Finally, unilateral approaches have consistently provided the procedural basis for the application of the method article and this means that tax treaties cannot operate independently of domestic law.

This chapter provides a comprehensive introduction to the mechanisms provided by countries either unilaterally or by way of bilateral tax treaties to eliminate double taxation. The authors identify when unilateral measures arise and the types of provisions that will be contained in domestic law. Thereafter, the authors discuss the importance of the distributive rule to emphasize that the method article is a relief for residual double taxation and, therefore, not the only means through which double taxation is avoided. The chapter then explains the provisions that constitute the method article, address the relationship between tax treaties and domestic law and evaluate the key differences between unilateral measures and articles 23A and 23B. The sections 1.5.-1.6. review the fundamental issues of interpretation of the method article and reflect upon whether tax treaties are still the most effective way to resolve double taxation.

1.2. Avoidance of double taxation through unilateral relief

1.2.1. Methods of unilateral relief

Unilateral relief will be provided to residents of a country in respect of foreign income taxed in another jurisdiction when there is no applicable tax treaty or when, despite being entitled to treaty benefits, the agreement does not cover specific taxes or sources of income (this is discussed further in section 1.3.). The domestic tax laws of a country may provide one of the following methods of relief for juridical double taxation:

– full exemption – the residence jurisdiction fully disregards the income generated in a foreign (or source) jurisdiction in calculating the taxable income of the taxpayer. This means that the residents of a country will only be taxed in that country on their domestic income;
– exemption with progression – whilst foreign-sourced income is exempt, the residence jurisdiction may require that this income be taken into account when determining the tax rate applicable to the taxpayer. The result will be a higher tax rate when a taxpayer has more foreign-sourced income. This is often done to prevent taxpayers from enjoying

the benefits of lower tax brackets by ensuring that a portion of their income is earned in a foreign jurisdiction;
- foreign tax credit – a taxpayer will be permitted to reduce the domestic taxes payable on their worldwide income by the amount of foreign taxes paid on that income.[3] A claim for a full credit of taxes paid, when the foreign tax jurisdiction has a higher tax rate than the residence jurisdiction, will be capped at the prevailing domestic rate; or
- deduction – the residence jurisdiction permits the resident taxpayer to deduct the taxes on foreign-sourced income from their domestic taxable income.

In practice, countries may adopt a mixture of these methods. The exemption method and foreign tax credit provide taxpayers with full relief from juridical double taxation, whilst the deduction method will only provide partial relief.[4] These methods are discussed extensively in the other chapters of this book.

Domestic tax law may also provide for relief from economic double taxation, which arises when the same income is taxed twice in the hands of different taxpayers.[5] This is usually the case when dividend payouts are concerned. Dividends will be taxed once at the corporate level, since distributions are made after tax, and again at the shareholder level. Some methods for corporate level relief include:[6]
- treatment of a dividend as a tax-deductible expense;
- taxation of distributed income at a lower rate than retained income (split-rate method); and
- dividend distribution tax applicable only when the distribution is made, which will then be tax free at shareholder level.

At the shareholder level, two types of relief may be available:[7]
- dividend credits, which provide the shareholder with a full or partial imputation as a tax credit, usually only available to domestic shareholders; and
- full or partial tax exemption of dividends that may be based upon the amount of shares held by the taxpayer (qualifying participation).

3. K. Holmes, *International Tax Policy and Double Tax Treaties* ch. 2 (IBFD 2007), Books IBFD.
4. O. Ostaszewska & B. Obuoforibo (eds.), *Roy Rohatgi on International Taxation* ch. 3 (IBFD 2018), Books IBFD.
5. Id.
6. Id., at sec. 3.2.1.
7. Id., at sec. 3.2.1.

1.2.2. History of unilateral relief

1.2.2.1. Exemption

Since limited international law constraining the imposition of taxes at a cross-border level exists, double taxation will, primarily, be dealt with unilaterally.[8] Historically, the territorial system applied by countries essentially operated as an exemption method, since it was previously too difficult to establish the worldwide income of a taxpayer.

1.2.2.2. Credit

Early examples of countries recognizing the need to extend reliefs include the United Kingdom's introduction, in 1916, of a relief for taxes paid in the Dominions, as a temporary war measure that was later made permanent by way of the 1920 Finance Act.[9] Similarly, the United States sought to provide substantial relief by way of a foreign tax credit, in 1919, based on the finding that the country's traders faced heavy taxes abroad and at home.[10] In the same year, the Netherlands provided an identical relief with respect to the taxation of dividends received by Dutch residents from foreign sources.[11]

Indeed, many countries have since introduced provisions that regulate the elimination of double taxation in their domestic tax law:[12]

> When international juridical double taxation arises, most countries provide at least some relief under their domestic law. Where such unilateral relief is granted, it usually applies in the same way in respect of income from all countries and may include limitations on the amount of relief that will be provided.[13]

Countries may not have or even want a complete treaty network to relieve double taxation, and the ability to provide unilateral relief can "reduce the

8. Holmes, *supra* n. 3, at p. 103.
9. C.J. Gregg, *Double Taxation*, 33 Transactions of the Grotius Society, p. 78 (1947).
10. Id.
11. Id.
12. T. Rixen & P. Schwarz, *Bargaining over the Avoidance of Double Taxation: Evidence from German Tax Treaties*, 65 FinanzArchiv/Public Finance Analysis 4, p. 445 (2009).
13. United Nations, *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* p. 7, para. 40 (United Nations 2019).

impact and significance of the obligations to provide elimination of double taxation under tax treaties".[14] For instance, there was a shared view amongst a number of South American countries in the 1990s "that they could attract all the foreign investment they needed without having a tax treaty network".[15] Although the approach has since changed, this view has been supported by a number of academics over time,[16] and it is, therefore, crucial to understand the key features of unilateral measures and their application in order to understand how they operate alongside the framework of tax treaties.

1.2.3. When does unilateral relief apply?

Provisions of domestic law specify the way in which the methods for elimination of double taxation are to be applied. Statutory guidance covers a range of issues including the allowable expenses for the computation of domestic tax liability and the types of taxes that are admissible for unilateral relief. Taxpayers, therefore, need to determine (i) whether their income will actually be deemed as arising in a foreign jurisdiction; (ii) the financial year in which the relief should be claimed; and (iii) the amount of foreign income that can be deducted/claimed.

A taxpayer needs to determine the nature of the foreign income earned and the method applicable to that category of income in the resident jurisdiction. A number of countries distinguish between passive and active income and duly apply different methods. For instance, Austria employs an exemption with the progression method for active income (such as income from a business) and for passive income (such as interest or royalties), a foreign tax credit is utilized.[17] It is important to determine whether foreign income corresponds to the domestic income against which a claim is being made, as the residence jurisdiction can reject relief on that basis. For instance, the United Kingdom only provides relief "for those foreign taxes, including

14. Trepelkov, Tonino & Halka, *supra* n. 1, at p. 120.
15. M. Waters, *For this relief, much thanks*, British Tax Review 6, p. 451 (1999).
16. For instance, *see* the discussion in T. Dagan, *International Tax Policy: Between Competition and Cooperation*, (Cambridge University Press 2018), making reference to Easson, *supra* n. 2; E.A. Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 Rutgers Law Review 428 (1963); and J. Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 Virginia Law Review 7 (1995).
17. Y. Schuchter & A. Kras, *Austria – Corporate Taxation – Country Analyses* sec. 6.1.4., Country Tax Guides IBFD (accessed 18 July 2022).

national, provincial and municipal taxes, which correspond to UK income or corporation tax".[18]

Further, taxpayers are provided with guidance, on the documentation required (as proof of receipt of foreign income) and the detail it should provide. This may often include the amount of income received, the date of payment, the source jurisdiction and the tax rate applied.

Taxpayers need to identify whether the carry forward or carry back of excess relief is permissible. Not all countries permit claims of excess relief, and, where it is permitted, specific guidance will apply. Domestic law provides guidance on the method of computing the unilateral relief. For instance, Germany requires that the maximum foreign tax credit is calculated separately for each foreign country, a per-country limitation, in which foreign income has been earned.[19] Additionally, countries may provide for losses incurred in the foreign jurisdiction in connection with the foreign income that has been subjected to double taxation, and, therefore, will be allowable and may be carried back or carried forward.

Countries often indicate how disputed foreign taxes and any interest, fees or penalties arising may be treated. In India, credits for disputed taxes are allowed in the year that income is assessed to tax in India, if evidence is provided by the taxpayer within 6 months from the end of the month in which the dispute is settled.[20] In addition, foreign tax credits are not available against interest fees or penalties.[21]

1.3. Avoidance of double taxation through treaties

Although many countries have maintained systems for unilateral relief, the system of reciprocal relief has emerged in parallel. When introducing the income tax relief for the Dominions in the Commons, Sir Young commented:

> [T]here is a great deal to be said for the provisions of this Clause which aim, at any rate, at putting individuals on an equal footing of taxation, whether their

18. J. Bennett & B. Obuoforibo, *United Kingdom – Corporate Taxation – Country Analyses* sec. 7.2.6., Country Tax Guides IBFD (accessed 18 July 2022).
19. A. Perdelwitz, *Germany – Corporate Taxation – Country Analyses* sec. 7.2.6., Country Tax Guides IBFD (accessed 18 July 2022).
20. S. Shah, *India – Corporate Taxation – Country Analyses* sec. 7.2.6., Country Tax Guides IBFD (accessed 18 July 2022).
21. Id.

> investments are within the United Kingdom or partly or wholly in other parts of the Empire. The idea, I believe, will be accomplished if the Dominions' Governments pass reciprocal legislation, as is suggested by the Royal Commission.[22]

Although the first treaty for the prevention of double taxation was signed in 1869 between Prussia and Saxony, countries also sought reciprocity for double taxation relief by agreeing to exempt foreign ships from income taxes if foreign countries provided similar treatment.[23] The Netherlands first adopted this principle in 1819, whilst the United States and the United Kingdom introduced similar provisions in 1921 and 1923, respectively.[24] These were later expanded to air transport and eventually led to an expansion of the number of agreements to relieve double taxation.

Whilst the two systems have emerged in tandem, where a tax treaty is available and applicable, the question of which will take precedence, or which should be examined first, will arise (this is discussed further in section 1.4.). Indeed, the relationship between domestic tax laws and the tax treaty must be clearly understood in order to apply the provisions of each framework correctly.

Under the framework of a tax treaty, "the two contracting states commit themselves to relinquishing or restricting their taxing rights".[25] The provisions of the tax treaty determine the circumstances under which income or capital is to be taxed in only one of the contracting states or when both states have a right to tax.[26] This means that the method article, typically contained in articles 23A and 23B of a tax treaty, is not the only means through which double taxation may be avoided. Certainly, "the application of the method article is not always necessary" and "in some cases, double taxation is avoided by the allocation rules themselves, namely when the allocation rules assign exclusive taxing rights to one state".[27] It is, therefore, useful to understand the circumstances in which the method article becomes applicable.

22. Hansard 1803-2005, Finance Bill Deb 7 July 1920, vol 131, col. 1566, available at https://api.parliament.uk/historic-hansard//commons/1920/jul/07/clause-26-relief-in-respect-of-dominion (accessed 18 July 2022).
23. Gregg, *supra* n. 9, at p. 79.
24. Id.
25. M. Lang, *Introduction to the Law of Double Taxation Conventions* ch. 3.1. (2nd ed., Linde 2013).
26. Id.
27. Id., at ch. 10.1.1.

1.3.1. The effect of distributive rules

The avoidance of double taxation is dealt with in two ways. First, by way of the distributive rules typically contained in chapters III and IV of a tax treaty based on the OECD Model Tax Convention (OECD Model)[28] or the UN Model Double Taxation Convention (UN Model)[29] and, second, when these rules do not provide an exclusive right to either the residence or source jurisdictions, the method article will apply. As a result, it is important to understand the circumstances under which the provisions of the method article, articles 23A and 23B, will be applied in order to eliminate double taxation.

Chapters III and IV of a tax treaty contain the allocation rules for the taxation of income and capital. They address the residence and source jurisdictions, as well as the distribution and limitation of their taxing rights. In many circumstances, "double taxation is already avoided through the application of a distributive rule that prevents the source state from taxing (the operative phrase being 'shall be taxable only' in the residence state".[30]

These distributive rules may provide an exclusive right to tax by expressly stating that the income or capital "shall be taxable only" in either the residence or the source state. For instance, article 8, concerning international shipping and air transport, provides that the profits of an enterprise of a contracting state from the operation of ships or aircraft in international traffic shall be taxable only in that state.[31] In this instance only the residence jurisdiction is entitled to tax and, therefore, no incidence of double taxation is likely to arise. Article 19 provides for government services and determines that the salaries, wages and similar remuneration paid by a contracting state to an individual, in respect of services rendered to that state, shall be taxable only in that state. As a result, the salaries, wages and similar remuneration earned, in respect of government services, will be exclusively taxed in the source jurisdiction.

28. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model* (2017)].
29. *United Nations Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2017), Treaties & Models IBFD [hereinafter *UN Model* (2017)].
30. E. Reimer & A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions* p. 1611 (Kluwer Law International 2015).
31. Art. 8 *OECD Model* (2017).

The provisions of a tax treaty may also determine that the income or capital in question "may be taxed" in either of the contracting states. For example, article 6, concerning the taxation of income from immovable property, provides that income derived by a resident of a contracting state, from immovable property, situated in the other contracting state, may be taxed in that other state.[32] When this is the case, both jurisdictions have a right to tax and double taxation is likely to occur. Overall, when the distributive rule preserves taxation in the source state or restricts the amount of taxes that can be levied by the source jurisdiction, elimination of double taxation by way of the method article will be necessary.[33]

1.3.2. Application and effect of the method article

1.3.2.1. Avoidance of residual double taxation

As discussed above, a variety of provisions of tax treaties seek to address double taxation, and the application of the method article will only arise when the distributive rule does not provide an exclusive taxing right to one jurisdiction. For this reason, it has been posited that "a more precise heading [for articles 23A and 23B] would be 'Methods for elimination of residual double taxation'".[34] Residual double taxation arises in instances in which the distributive rule provides both contracting states with the ability to tax income or capital, including when the tax liability is reduced. When the distributive rule is unable to provide an absolute right to one jurisdiction, this residual double taxation will then be addressed by the method article.

Given that articles 23A and 23B are drafted in a general way, once taxpayers have familiarized themselves with the content of the provisions and made reference to the Commentary, they will then turn to the guidance in the relevant domestic law to determine the computation methods, the classification of income or capital and the characterization of the foreign entity. The Commentary on the OECD Model tries to address the operation and effects of the methods by providing examples in figures. These examples simply identify and compare the amount of tax surrendered by the residence jurisdiction but do not determine the specific rules of implementation.

32. Art. 6 *OECD Model* (2017).
33. Reimer & Rust, *supra* n. 30, at p. 1611.
34. Id.

1.3.2.2. Articles 23A and 23B

Articles 23A and 23B of the OECD Model deal with juridical double taxation arising when either both contracting states subject the same person to tax on their worldwide income or capital, or the residence and source jurisdiction impose tax on income or capital arising in the source state.[35] It applies to the resident jurisdiction and provides countries with the options of the exemption method or the credit method, however, it is not expected that countries should apply only one of the methods – they should be supplemented by elements of one another.[36] Articles 23A and 23B of the UN Model similarly deal with juridical double taxation arising under the same circumstances as those identified by the OECD Model.

Countries may opt to either use the exemption or credit method or apply different methods to different circumstances. However, developing countries, as stated in the Commentary on Article 23A and 23B of the UN Model,[37] expressed concerns about how the foreign tax credit, and the potential for the benefits of law taxes or special concessions offered by them, may "in large part inure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed".[38] The outcome would be the shifting of revenue from the developing country to the capital-exporting county.[39] This particular challenge is addressed by the tax-sparing provision in article 23B (which is briefly explained below).

Article 23A(1) of both OECD and UN Models, provides for the exemption method and requires that the resident state exempt income or capital subject to tax in the source state. However, this is only possible to the extent that the source state is permitted to tax based on the provisions of the tax treaty because the income or capital are derived by or owned by a resident of the other state.

Article 23A(2) permits a credit in the resident jurisdiction for taxes on dividends and interest incurred in the source jurisdiction. However, this deduc-

35. *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* para. 3 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Articles 23A and 23B* (2017)].
36. Reimer & Rust, *supra* n. 30, at p. 1611.
37. *United Nations Model Double Taxation Convention between Developed and Developing Countries: Commentary on Articles 23A and 23B* para. 3 (1 Jan. 2017), Treaties & Models IBFD.
38. Id.
39. Id.

tion should not exceed the domestic rate applicable, and it will not apply when the source state also exempts or provides a deduction for dividends and interest. The UN Model extends this treatment to royalties and fees for technical services. Article 23A(3) gives way for the use of the exemption with progression (as explained in section 1.2.1.).

Finally, article 23A(4) provides for the switchover rule and stipulates that article 23A(1) will not apply if the source state applies the provisions of the tax treaty to exempt the income or capital, or if it applies the lower rate applicable to articles 10(2) and 11(2)[40] on dividends and interest. According to the OECD Model Commentary on Articles 10(2) and 11(2) of the OECD Model,[41] "the purpose of this paragraph is to avoid double non-taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or on the interpretation of the provisions of the Convention".[42] Article 23A(4) applies when the source state interprets the facts of a case or the provisions of the tax treaty that results in its right to tax the income or capital being eliminated or limits the tax that can be imposed, and the residence state adopts a different interpretation that establishes that the income or capital may be taxed in the source state.[43] Under these circumstances, the residence jurisdiction is entitled to withhold the exemption. The UN Model expands the application of this rule to royalties (article 12) and fees for technical services (article 12A).

Article 23B refers to the credit method and obliges the resident state to provide a deduction from the tax on income or capital for the amount equal to the taxes paid in the source state, and similar to article 23A(1), this is only applicable to a limited extent (as mentioned above). The deduction should not exceed the taxes that would arise in the resident jurisdiction. If the income is exempt, this may be taken into account when calculating the amount of tax, and this permits the application of progressive rates.[44]

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40. Art. 10(2) of the OECD Model provides that, "where dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) 5 per cent of the gross amount of the dividends if the beneficial owner [meets a specified threshold] … [or] b) 15 per cent of the gross amount of the dividends in all other cases". Under art. 11 of the OECD Model, similar circumstances will result in a tax not exceeding 10% of the gross amount of the interest.
41. *OECD Model: Commentary on Articles 10 and 11* (2017).
42. Para 56.1 *OECD Model: Commentary on Articles 23A and 23B* (2017).
43. Id.
44. G. Kofler & F. Pötgens, *Article 23: Methods for Elimination of Double Taxation* sec. 1.1.1.3., Global Topics IBFD (accessed 18 July 2022).

The two articles do not provide further detail regarding their application: "The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is computed, this being left to the domestic laws and practice applicable."[45] As a result, significant reference will need to be made to domestic law to determine the following: (i) the computation methods; (ii) the credit limitation overall – per country or on the item of income; (iii) the treatment of losses; and (iv) timing issues, among other factors.[46]

Along with the elements identified above, domestic law, particularly among common law jurisdictions, provides guidance on when income or capital is considered to have a foreign or domestic source.[47] This is important for both contracting states because, "if they employ the credit method but defer to their domestic rules on the foreign tax credit, granting such credit only if the relevant income has its source in the other contracting state".[48] However, this may give rise to conflicts of interpretation that could result in double taxation remaining unresolved. To remedy this issue, some tax treaties include deemed source rules, which determine that when income may be taxed in the other contracting state, it, therefore, has its source there.[49]

The interpretation of specified elements of a tax treaty may result in additional conflicts of interpretation or qualification. According to the Commentary on Articles 23A and 23B of the OECD Model,[50] interpretation of the phrase, "may be taxed in the other contracting state in accordance with the provisions of this convention",[51] contained in both articles, is especially important when the residence and source jurisdiction classify the same item of income or capital differently.[52] This gives rise to conflicts of qualification, which are dealt with extensively, later in this book. There are also specific challenges of interpretation that arise due to the "different interpretation of facts or different interpretation of the provisions of the Convention".[53]

Since the implementation of the methods will be reliant on domestic law, there are instances when the residence state and the source state interpret

45. Para. 32 *OECD Model: Commentary on Articles 23A and 23B* (2017).
46. Kofler & Pötgens, *supra* n. 44, at sec. 1.1.1.4.
47. Id.
48. Id.
49. Id.
50. *OECD Model: Commentary on Articles 23A and 23B* (2017).
51. Articles 23A(1) and 23B(1) *OECD Model* (2017).
52. Paragraph 32.2 *OECD Model: Commentary on Articles 23A and 23B* (2017).
53. Paragraph 32.5 *OECD Model: Commentary on Articles 23A and 23B* (2017).

the provisions of the tax treaty or the facts of the case under consideration differently, and this results in an interpretation conflict giving rise to double taxation. When this is the case, such conflicts will need to be resolved by way of a mutual agreement procedure, in accordance with article 25 of the OECD and UN Models.[54]

1.4. Comparison between unilateral relief and treaty relief

Since tax treaties are a feature of international public law, the contracting states should determine how they are to be implemented into domestic law.[55] This will depend on the constitutional framework of the country concerned, which may identify that tax treaties either hold the same status, take precedence over, or are subordinate to domestic law.[56] In addition, countries will need to determine whether tax treaties have direct domestic effect, or, will require a legislative process to be incorporated into national law.[57]

Tax treaties make reference to the rules of domestic law and provide additional guidance. When the application of the tax treaties provides a different outcome than domestic law, then tax treaty law becomes more important, hence the reference to a pragmatic approach.[58] As a result, any emergent conflict between domestic law and the method article contained in the tax treaties "should be resolved in favour of the DTC rule".[59] However, to determine the tax liability of a foreign taxpayer, domestic law needs to be consulted first and then referred to the tax treaty to identify whether the contracting state has the right to tax, and if so, whether the taxpayer is entitled to any relief.[60] If the contracting state has surrendered the right, then there is no need to go any further, however, when the "may be taxable only" instances arise, then a taxpayer has to concern themselves with both domestic and treaty law. This is particularly important since domestic law also provides some of the rules relevant to the implementation of the method article.

54. Kofler & Pötgens, *supra* n. 44, at sec. 2.16.4.
55. Lang, *supra* n. 25, at ch. 3.3.1.
56. Id.
57. Ostaszewska & Obuoforibo, *supra* n. 4, at sec. 24.1.
58. Lang, *supra* n. 25, at ch. 3.3.2.
59. Id., at ch. 3.3.1.
60. Id., at ch. 3.3.4.

Indeed, although the tax treaty will take priority, there remains the problem of application of the provisions. Since the method article, in particular, is drafted in a general way, its implementation will be dependent on the provisions of domestic law and, this means that:

> [D]omestic procedural law can and must shape the conditions for providing relief from double taxation to a great extent. While the exemption method in the common form of article 23A of the OECD Model does not consider the actual tax implications in the source state and is, therefore, from a procedural perspective, rather easy to apply, the credit method requires more observation. As the credit method requires a credit of foreign tax paid, the resident state will want to ensure that there actually is a foreign tax that is due, correctly calculated and effectively paid. As tax treaties generally do not specify how these facts are to be established, the laws of evidence of the residence state apply.[61]

With the equivalence between the two systems, it is useful to investigate the key differences between them, since they could give rise to conflicting outcomes for the taxpayer.

1.4.1. Key differences between unilateral measures and the method article

1.4.1.1. Advantages of unilateral relief

Unilateral measures provide more methods of relief, particularly the use of the deduction method and including loss situations. Domestic law may also permit credits for other taxes not covered by tax treaties, and may address economic double taxation, especially where dividends are concerned.[62] Tax treaty deductions may be difficult to obtain in some circumstances, particularly when the use of the method article may result in a worse situation for the taxpayer.

What has emerged from sections 1.1.-1.3. is that unilateral measures will often provide more detail and guidance regarding their operation, in comparison to the method article. Since the provisions of article 23 "fail to ar-

61. F. Fiala, *The Methods to Avoid Double Taxation and their Implementation in Domestic Law*, in *Tax Treaties and Procedural Law* p. 150 (M. Lang et al. eds., IBFD 2020), Books IBFD.
62. For instance, "economic double taxation created by transfer pricing adjustments to corresponding adjustments under article 9(2) of the OECD Model" (G. Kofler & F. Pötgens, *supra* n. 44, at sec. 1.1.2.1.3.).

range for their implementation”,[63] the elimination of double taxation under a tax treaty will ultimately be reliant on domestic law, which “becomes applicable to close the gaps”.[64] Not only does domestic law fulfil a supplementary role, but it may also provide relief when a treaty fails to eliminate double taxation or only does so partially.[65]

1.4.1.2. Advantages of treaty relief

Overall, tax treaties provide greater legal certainty to foreign taxpayers. Whilst unilateral provisions can be subjected to change more often, treaties will require a frequently lengthy process of renegotiation between the two contracting jurisdictions. Tax treaties also provide reduced rates in comparison to domestic tax law, and this often reduces the likelihood for excess credits. In addition, whilst domestic law often provides for the credit method, treaty law primarily permits exemptions, which entails less effort on the part of the taxpayer.

There are instances in which domestic law does not recognize all income as foreign, and this may result in no relief being granted to the taxpayer under the unilateral measures. In such cases, it is often more beneficial to have treaty relief as the tax treaty may categorize income or capital as foreign and, therefore, entitled to relief from double taxation.

One of the situations in which unilateral measures “may be ineffective to prevent double taxation is where a transfer pricing adjustment has been made”.[66] Article 9(2), regarding the elimination of economic double taxation in the context of transfer pricing, can, therefore, be more beneficial for a taxpayer. It deals with instances when, following an assessment, an adjustment is made to the amount of taxes paid and that gives rise to double taxation. The other contracting state may introduce a corresponding adjustment to balance the primary adjustment made.[67] This is most effectively arrived at by way of mutual agreement between the competent authorities concerned.

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63. Reimer & Rust, *supra* n. 30, at p. 1615.
64. Id.
65. *See* the discussion provided by Rust in Reimer & Rust, *supra* n. 30, at p. 1615, identifying that “it remains permissible under treaty law to resort, as a supplementary means, to domestic legislation on unilateral elimination of double taxation”. This supplementary relief should not result in double non-taxation.
66. Easson, *supra* n. 2, at p. 622.
67. Kofler & Pötgens, *supra* n. 44, at sec. 4.1.

1.5. Are tax treaties the most effective means of eliminating double taxation?

It has frequently been recognized that the methods to eliminate double taxation under a tax treaty cannot be implemented without the rules of application provided for in domestic law. Due to the relationship of equivalence between a treaty and domestic law, the tax treaty is then viewed as a "stencil" of the unilateral measures used by a country:

> In reality a treaty is more correctly described as an instrument which refines and improves existing provisions in domestic legislation which are designated to eliminate international juridical double taxation, i.e., most countries have in their own tax law provisions which are designated to alleviate double taxation, and the treaty serves to assist in that process and better integrate it with the corresponding provisions in the treaty partner's law.[68]

Due to the broader coverage provided by unilateral measures and the eventual deference to domestic law, where implementation of the method article is concerned, a number of academics have questioned whether tax treaties are the most effective way of eliminating double taxation. Indeed, Easson, in questioning whether we still need tax treaties, states:

> Rather than seek an alternative to tax treaties, perhaps we should ask whether there is any good reason for a country to maintain two separate international tax regimes – a treaty regime and a non-treaty regime. Could the undoubted benefits that flow from tax treaties be achieved just as well by unilateral action?[69]

Dagan observes that, "although treaties and unilateral mechanisms achieve approximately the same reduction in double taxation, they allocate tax revenues differently"; by "constraining the host's power to tax, tax treaties essentially give residence countries a larger piece of the tax-revenue pie".[70] Indeed, this has been a concern for developing countries in particular. This perspective has also been shared by American counterparts, who have found that:

> [T]he U.S. has unilaterally provided for the avoidance of double taxation for its own citizens, corporations, and residents through the foreign tax credit provisions of the Internal Revenue Code. Because the United States has, thus, taken this unilateral action, the treaties do not need to make – and do not in fact, make – any substantial change in the pattern of U.S. taxation. All that

68. A. Amatucci, *International Tax Law* p. 164 (Wolters Kluwer Law 2012).
69. Easson, *supra* n. 2, at p. 621.
70. Dagan, *supra* n. 16, at p. 104.

Notes

IBFD

The Home of International Taxation

Contact

IBFD Head Office
Tel.: +31-20-554 0100 (GMT+2)
Email: info@ibfd.org

Visitors' Address:
Rietlandpark 301
1019 DW, Amsterdam
The Netherlands

Postal Address:
P.O. Box 20237
1000 HE Amsterdam
The Netherlands