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# Priority Rules in Tax Treaties

The Relationship between the Different Distributive  
Rules in the OECD and the UN Models

28

European and International  
Tax Law and Policy Series

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# Priority Rules in Tax Treaties

## Why this book?

Thus far, the priority relations between the different distributive rules of the OECD and UN Models have not been comprehensively studied in academia. Nevertheless, the questions of demarcation between the individual provisions are of central importance for the application of a tax treaty. The right of source states to tax and the question of which method is applicable for avoiding double taxation depends on this determination. In some instances, explicit priority rules regulate which distributive rule shall take precedence in the event of overlapping scopes of application between two (or more) distributive rules. Other relations are not specifically dealt with in the OECD and UN Models and are implicit. In both cases, interpretive challenges arise that can only be resolved through intensive analyses of the distributive rules in question. This book aims to provide in-depth analyses of current issues concerning the relations between various distributive rules. The topics covered include: - the role of and the relationship between the distributive rules in tax treaties; - the relevance of article 7(4) of the OECD and UN Models; - the relevance of article 10(4), article 11(4) and article 12(3) of the OECD Model; - the relationship between article 12A and article 12B of the UN Model and the other distributive rules of the UN Model; - the different distributive rules for capital gains (article 13 of the OECD Model) and for taxes on capital (article 22 of the OECD Model) and their relation to the other distributive rules of the OECD Model; and - the different distributive rules of the OECD Model Convention on Estates, Inheritances and Gifts.

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## Preface

Tax treaties have both a personal and substantive scope. If a tax treaty is applicable, all covered elements of income and capital of a resident must be assigned to a single distributive rule. This assignment can lead to difficulties for various reasons, one of which is that the scopes of application of the various distributive rules overlap. A detailed analysis of the relations between the distributive rules is required to resolve these difficulties. Some of these relations are explicitly addressed in the OECD and UN Models, where priority is given to a specific distributive rule, whereas others are implicit. Determining which distributive rule is applicable is of utmost practical relevance. The right of source states to tax and the question of which method is applicable to avoid double taxation depends on this determination. Thus far, little research has focused on the relationships between the different distributive rules.

To address these and other important and current issues concerning the relationships between the distributive rules, the 29th Viennese Symposium on International Tax Law was held on 13 June 2022 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 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 Caroline Ristic, Nina Nimmerrichter, Myriam Pereira de Milinic and Christian Knotzer who were the main people 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 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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## List of Abbreviations

AOA	Authorised OECD Approach
arg.	Argumentum
art.	Article
ATO	Australian Taxation Office
B2B	Business to Business
B2C	Business to Consumer
BEPS	Base Erosion and Profit Shifting
BFH	Bundesfinanzhof
Bull. Intl. Taxn.	Bulletin for International Taxation
ch.	Chapter
DBA	Doppelbesteuerungsabkommen
DIRs	Dividends, interest and royalties
DIT	Indian Director of Income Tax
DTA	Double taxation agreement
DTT	Double tax treaty
e.g.	Exempli gratia
etc.	Et cetera
FB	Fixed base
HC	High Court
i.e.	Id est
IBFD	International Bureau of Fiscal Documentation
id.	Idem
ITAT	Income Tax Appellate Tribunal
ITO	Income Tax Officer
IWB	Internationales Steuer- und Wirtschaftsrecht (journal)
MAP	Mutual agreement procedure
MNE	Multinational enterprise
n.	Number
OECD	Organisation for Economic Co-operation and Development
OECD Commentary	OECD Model Tax Convention on Income and on Capital: Commentary
OECD MEIG	OECD Model on Estates, Inheritances and on Gifts
OECD Model	OECD Model Tax Convention on Income and on Capital
OEEC	Organisation for European Economic Co-operation
p.	Page
PE	Permanent establishment
PoEM	Place of effective management
Sec.	Section

## List of Abbreviations

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seq.	Sequens
StuW	Steuer und Wirtschaft (journal)
SWI	Steuer und Wirtschaft International (journal)
UN	United Nations
UN Committee	UN's Committee of Experts on International Cooperation in Tax Matters
UN Model	United Nations Model Double Taxation Convention between Developed and Developing Countries
US	United States
USD	United States Dollar
VCLT	Vienna Convention on the Law of Treaties
VfGH	Verfassungsgerichtshof (Constitutional Court of Austria)
VwGH	Verwaltungsgerichtshof (Supreme Administrative Court of Austria)
WG28	OECD Working Group Number 28
WP	Working Party
WP14	Working Party 14

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## Chapter 1

### The Role of and the Relationship between the Distributive Rules in Tax Treaties

Stefano Castagna

#### 1.1. Beginning a journey into distributive rules: A primer on the main issues

This chapter will introduce the basic inherent and implied concepts behind and the characteristics of distributive rules in order to provide guidance throughout the journey and strengthen the bounty of the analyses presented in the following sections. This will allow the introduction of the most fundamental definitions and understandings of how such rules operate and their nature. This chapter will briefly outline the structure of the OECD Model Tax Convention on Income and on Capital (OECD Model); the main rules and discussions surrounding the identification of distributive rules; their role and the concepts behind them, as well as suggest their primary classes and characteristics. In so doing, it will clarify where distributive rules can be found within the models, the functioning of distributive rules and their relationship with respect to the sovereign power of source and residence states; the ways that the drafters of the models have regulated the relationship between them; and the different types of income that are regulated through them. Usually, there are only minor – albeit, at times, important – differences between the OECD Model and United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model) and an actual treaty;<sup>1</sup> however, they both have a very similar structure. Consequently, the analysis of the actual treaties can depend on that of the respective models, as will be done in this chapter.

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1. Compare with S. Castagna, *Essential Elements of Taxation – Investment Protection and Dispute Settlement*, in *International Arbitration and EU Law* (J.R. Mata Dona & N. Lavranos eds., Elgar 2021).

## 1.2. The structure of the OECD Model

### 1.2.1. Personal scope

The first thing to ensure when applying a tax treaty is that it covers the interested taxpayers. The personal scope of tax treaties is typically enshrined in article 1, which states that the convention applies to “persons who are residents of one or both of the Contracting States”. Article 4(1) defines the term “resident of a Contracting State”.

### 1.2.2. Substantive scope

The second element to take into consideration is the substantive scope of a tax treaty that is found in article 2, which is structured in four different paragraphs. Paragraph 1 states the general principle that “[t]his Convention shall apply to taxes on income and on capital”. Its meaning and scope are further defined in paragraph 2.<sup>2</sup> Article 2 then enables the contracting states to specify which taxes are included in the scope of the convention “in particular”. The article concludes with paragraph 4, which ensures that the treaty will apply to “identical or substantially similar” taxes imposed after the date of signature in addition to or as a replacement of the taxes already existing at the time of signature. This last provision has likely been inserted to ensure, among other reasons, that there is no need for amendment of the list in paragraph 3.<sup>3</sup>

### 1.2.3. Distributive rules

There can be different views on what constitutes distributive rules. One perspective might be that distributive rules in tax treaties could be defined depending on their proximity to an average overall set of characteristics between those provisions in articles 6-22 of the OECD Model. Otherwise, it is possible to consider them as “rules which provide a total or partial tax exemption on a given possible tax claim to avoid double taxation”. This is because they allocate taxing powers between the contracting states by granting an exemption from taxation.<sup>4</sup>

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2. P. Baker, *Double Tax Conventions*, sec. 2B.04 (Sweet & Maxwell 2021).

3. Id., at 2B.06.

4. M. Lang, *Verteilungsnormen*, in *Doppelbesteuerung: Festgabe : zum 75. Geburtstag von Prof. Dr. Dr. h.c. Franz Wassermeyer : 75 Beiträge zum Recht der DBA (1. Auflage.)* m.no. 1 (W. Wassermeyer ed., C.H. Beck 2015).



## 1.2.4. The methods to avoid double taxation

There might still be the need for a rule that coordinates how double taxation will be relieved even if the distributive rules are perfectly applied.<sup>5</sup> Both the OECD and the UN Models provide two different articles that could be chosen to apply alternatively and possibly in combination within a treaty, and both are directed to the *country of residence*. These are found in article 23A (exemption method) and article 23B (credit method).

## 1.3. Identifying distributive rules

### 1.3.1. Articles 6-22 of the OECD Model

As noted above, this is the part of the two model conventions that contains most of the distributive rules. Whether all of them can be classified as such is up for debate. However, the model treaties just label each article with their respective title based on the class of taxes or the matters that they address. The function of distributive rules is to create an exemption or limitation to the right to tax<sup>6</sup> so that there is at least a limited overlap in the power to tax between the two states. In principal, they are addressed in the source state and decide whether and how much it may tax. Consequently, the rights to tax are divided between the two contracting states. Whether the right to tax will be exercised will depend on whether the source state wants to exercise it through national legislation.<sup>7</sup> As a consequence, double non-taxation is always possible.<sup>8</sup>

### 1.3.2. Article 9 of the OECD Model

Article 9 is placed within the block of distributive rules but is peculiar. It ensures that when, between associated enterprises:

[C]onditions are made or imposed [...] in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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5. Baker, *supra* n. 2, at 23B.01.

6. Lang, *supra* n. 4, at m.no. 2.

7. Id.

8. Id., at m.no. 3.

The function and purpose of article 9 is to limit the capability of the contracting states to assess business profits of multinational enterprises only to a maximum amount to be determined according to terms and conditions that would have differed had the parties to a given transaction been unrelated.<sup>9</sup> This principle is commonly known as the arm's length principle. The different features of article 9 are clear and follow the different purpose that it has with respect to distributive rules. It has likely been positioned here so that it can systematically be placed next to articles 7 and 8.<sup>10</sup> Its objective is not to partially or totally exclude the power to tax a given tax claim of one state.

### 1.3.3. Article 20 of the OECD Model

Article 20 is another strange type of article within the model convention. Its text is quite brief, and it simply states:

Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

If one wants to consider distributive rules only those who have similar characteristics to the rest of the group, one should consider the different anomalies of article 20. As noted by relevant literature,<sup>11</sup> there are many peculiarities in this brief text. Surely the article is within the majority of those that address payments (such as articles 6(2), 10(1), 11(1), 12(2), 15(2)(b), 16, 18, 19 and 21(2)). However, the “payments” it refers to do not necessarily constitute income as mentioned above. The lack of mention of a particular category to which “payments” refer is proper only for article 16 in addition to article 20, which refers to “fees”. Some conclude that article 20's reference to payments and not “income” would suffice for settling the matter

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9. G. Kofler, *Article 9 – Associated Enterprises*, in *Klaus Vogel on Double Taxation Conventions* m.no. 5, p. 596 (4th ed., A. Rust & E. Reimer eds., Wolters Kluwer Law & Business 2015).

10. Id.

11. L. De Broe, *Students (Art. 20 OECD Model Convention)*, in *Source Versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives* p. 357 (M. Lang et al. eds., Kluwer Law International 2008); M. Herm, *Student Article in Model Conventions and in Tax Treaties*, 32 *Intertax* 2, pp. 69 and 74 (2004); and Baker, *supra* n. 2, at 20B.01.

negatively.<sup>12</sup> However, this should not be the case since the term “income” can have several different meanings (and therefore include “payments”) such as profits, gains and remuneration.<sup>13</sup>

Another element that could be considered is the absence of an explicit priority rule that refers to it. As will be seen in section 1.5.3., explicit priority rules are typical of distributive rules, and it is rare for an article not to refer to or be referred to by another. However, there are also other articles, such as article 8, that are never mentioned and do not expressly indicate any other distributive rule even though there is no doubt that article 8 is a distributive rule. In addition, consideration should also be made to the fact that articles 20 and 15 may overlap in their application, which results in the need to resort to an interpretation of the treaty.<sup>14</sup> This is the case, for example, when the activity of studying or training is a component of the duties under an employment contract, and the employer is also paying a salary for the maintenance of the student during this period of time.<sup>15</sup> However, as will be discussed later, this also occurs in many other rules in the OECD Model, and article 20 has a broader scope than article 15 as the former also encompasses items of income, such as scholarships, that would not necessarily fall under article 15. Furthermore, even if every item of income falling within the scope of article 20 was to fall within article 15 or other articles rendering article 20 inoperable, the nature of article 20 under the second definition provided would not change since it would not alter what constitutes article 20 but whether it is effective. It would therefore still be a distributive rule under this view – albeit ineffective.

It should also be considered that article 20 does not require the payee to be a resident of one of the contracting states since the student could move residence to a third state after beginning to live in the state where they are studying.<sup>16</sup> However, it must be noted that article 19(1)(a) and 19(2)(a) do not necessarily apply expressly to residents. Consequently, article 20 would

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12. According to M. Lang, *Does Art. 20 of the OECD Model Convention Really Fit into Tax Treaties?*, in *Tax Polymath: A Life in International Taxation* footnote 7 (P. Baker & C. Bobbett eds., IBFD 2010), Books IBFD, the following authorities sustain the position: F. Wassermeyer, *Art. 20 Studenten*, in *Doppelbesteuerung* art. 20, m.no. 15 (H. Debatin & F. Wassermeyer eds., C.H. Beck 1997); S. Meurer, *Artikel 20 Studenten*, in *Doppelbesteuerungsabkommen* art. 20, m.no. 4 (5th ed., K. Vogel & M. Lehner eds., C.H. Beck 2008); and J. Bauer, *Studenten, Gastlehrer und Gastprofessoren im DBA Recht*, in *Arbeitnehmer im Recht der Doppelbesteuerungsabkommen* p. 231 (W. Gassner et al. eds., Linde 2003).

13. Lang, *id.*, at p. 259.

14. *Id.*, at p. 260.

15. *Id.*

16. *Id.*, at p. 261.

not be the only one to do so. Whether article 1 restricts the scope of the treaty regardless of the wording of the distributive rules in this respect is another matter to ponder.

A further matter is the fact that article 20 does not expressly address the source or resident state. In fact, it explicitly excludes its application if the source of the payments is the state in which the student is present.<sup>17</sup> It does not mention whether the other contracting state in which the student is or was a resident immediately before the educational visit has any power to tax at all. This is a unique feature of article 20 with respect to all other distributive rules. It seems that, for this and other reasons (such as encouraging double non-taxation),<sup>18</sup> article 20 should not be seen to “completely fit into the system of application rules”.<sup>19</sup> In fact, the likely consequence would be double non-taxation of the student if he changes residence to the country in which the study activity is performed.<sup>20</sup>

Under the second definition of “distributive rule” that is given, there might instead be little doubt that article 20 is a distributive rule. It excludes the possible taxation of payments that can constitute a taxable element and prevent double taxation as a consequence by excluding the possibility of one state to tax. The other state retains any power to tax that it had, although it might decide to not use it. If the student’s permanence is of such a duration that their residence is changed to that of the study state, then the consequence of such a change of residence is that there is the impossibility of the state of origin to tax the student as stated above. The effect of this is non-taxation. This might not always be the case, especially since states have often disallowed the application of article 20 for income derived from employment or services.<sup>21</sup> However, the fact that the application of article 20 might often lead to double non-taxation could not necessarily be considered an issue if the view is adopted that the above definition of “distributive rules” is to be applied: double non-taxation is the avoidance of double taxation per se. Therefore, under the given definition of “distributive rules”, article 20 just seems to be the simplest distributive rule currently in the model.

The difference in definition therefore determines the outcome of whether article 20 is a distributive rule or not. However, it must be noted that even

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17. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 20* (23 Nov. 2017), Treaties & Models IBFD.

18. Lang, *supra* n. 12, at p. 267.

19. Id.

20. Lang, *supra* n. 4, at m.no. 19.

21. *Compare with Baker, supra* n. 2, at 20B.04.

a proponent of the definition that is considered could agree that article 20 does not easily fit into the system of distributive rules, even though it is one because of its very narrow scope and objective. In this context, it would be an *atypical* distributive rule. Article 20 could be inserted in an ad hoc treaty for students or directly inserted in legislation.<sup>22</sup>

#### 1.3.4. Definitions

As mentioned above, there are several definitions within both the UN and OECD Models that will be discussed in turn.

There are special definitions at times within distributive rules and other articles, such as (i) article 6, which defines “immovable property” in paragraph 2; (ii) article 9, which indirectly defines what constitute “associated enterprises”; (iii) article 10(3) (“dividends”); (iv) article 11(3) (“interests”); and (v) article 12(2) (“royalties”), which also contains definitions. A further article that does so is article 29, which contains the definition of “qualified person”. One important matter that arises with all of these definitions can be found both in *ad hoc* articles written that contain definitions and those dedicated to the discipline of the allocation of a given class of income. It is whether the latter definitions also apply with respect to other articles of the convention. This might not be a trivial matter, especially if there are deviations from the OECD Model that incorporate terms defined in specialized articles in other articles of the same convention. The practical consequence in such a case is that the interpretative outcome may or may not change in favour of the taxpayer. As with the case of many other issues of international taxation, there are two different theories that have opposing views on the matter.<sup>23</sup> The fact of the matter is that, in any event, there are some definitions that articles will have used other than those in which they have been defined due to an expressed reference. For example, article 13(4) expressly refers to “immovable property, as defined in Article 6”, while article 13(1) states that the scope of application of the paragraph is the “alienation of immovable property referred to in Article 6”. Another matter pertains not to a distributive rule but to article 24(4), which particularly reads:

Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other

22. Insertion in legislation has been suggested by Lang, *supra* n. 12, at p. 267.

23. Compare with a discussion on the issue J.F. Avery Jones et al., *Whether the Definition of Dividend Limited to the Dividend Article Applies to the Double Taxation Relief Article Granting Underlying Credit*, 53 Bull. Intl. Taxn. 3 (1999), Journal Articles & Opinion Pieces IBFD.

disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

There is clearly an explicit reference to the articles that define interest and royalties in addition to article 9 on transfer pricing. All of these definitions may interact with the distributive rules but are not *by themselves* distributive rules.

Many definitions are also contained in an article drafted for the purpose of providing definitions, such as article 3. It contains a list of the following terms and their respective standard definitions for the purpose of the convention: “person”, “company”, “enterprise”, “enterprise of a Contracting State”, “enterprise of the other Contracting State”, “international traffic”, “competent authority” (to be specified by the respective parties), the term “national”, “business” (in a limited way by indicating what it will also include within its meaning) and “recognised pension fund”.<sup>24</sup> Although these definitions are expressly listed within article 3, it is fundamental to note that they apply “unless the context otherwise requires” under the first sentence of article 3(1). This clause limits the application of the definitions within article 3(1) in order to grant a national judge more discretion “in countries that adhere to a strict constructionism”.<sup>25</sup>

However, article 3 is not the only article of the models that contains definitions. These are also found in article 4 that, as noted above, defines the meaning of “resident” and in article 5, which defines a permanent establishment (PE). Some distributive rules directly refer to and need the support of such definitions in order to be properly understood, especially with regards to those contained in article 3. “Person” is used in articles 11, 12 and 17. “Company” is found in articles 10 and 16, and “enterprise”, “enterprise of a Contracting State” and/or “enterprise of the other Contracting State” are in articles 7, 8, 13 and 22. “International traffic” is in articles 8, 13, 15 and 22. “Competent authority” is not in any distributive rule, while the term “national” can be found in article 19 and “business” is in articles 7, 8 10, 11, 12, 19, 20, 21 and 22. In addition, the expression “recognised pension fund” is not in any distributive rule.

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24. OECD Model: *Commentary on Article 3* (2017).

25. A.P. Dourado et al., *Article 3 – General Definitions*, in *Klaus Vogel on Double Taxation Conventions*, vol. 1, m.no. 15, p. 183 (4th ed., A. Rust & E. Reimer eds., Wolters Kluwer Law & Business 2015).

## 1.4. The role of the distributive rules

### 1.4.1. Exclusion of taxation rights in the source state

An exclusion of the source state's taxation rights typically occurs through explicitly granting taxation to the residence state. Tax treaties aim at eliminating double taxation, and distributive rules operate so that the areas of overlapping jurisdiction of the contracting states are eliminated, or at least diminished. One of the possible ways with which this can be done is through the exclusion of the source state's taxation rights. To do so, different legal techniques are used, and each will now be analysed.

There can be exclusions through a main distributive rule. In this regard, one of the first articles that can be considered as belonging to this category is article 7(1), wherein the first part of the first sentence concerning business profits states that they can be taxed "only in that State" unless there is a PE in the other state. Consequently, under article 7, income of a resident of that particular state cannot be taxed by the source jurisdiction. Article 8(1) indicates that profits from the operation of ships or aircraft in international traffic can be taxed "only in that State" to which the enterprise belongs. Therefore, the income of a company resident in State A and owning ships that operate in international traffic by shipping goods around the world will be taxed exclusively in the country of residence; articles 12(1) and 13(3) are similar.

There are also exceptions to other distributive rules found within the same article. This is the case of article 15(2), which ensures that income "shall be taxable only in the first-mentioned State" which is the residence state as an exception to article 15(1). As a consequence, if an employee is present in the state where they work for a period not exceeding an aggregated 183 days in any 12-month period commencing or ending in the fiscal year; the employer is not a resident of the source state; and the remuneration is not borne by a PE of the employer in the source state, then the resident state has exclusive taxation of the amounts. Finally, also article 19 addressing government services contains some relevant provisions in 19(1)(b) and 19(2)(b). Both of them constitute exceptions to the respective letters (a). Article 19(1)(b) deals with salaries, wages and "other similar remuneration" and imposes that the income "shall be taxable only in the other Contracting State" in the case that an individual is a national of the resident state or he has acquired residency not just because of the government services rendered. Article 19(2)(b) instead addresses pensions if an employee is a national or resident of that state, and it provides that the income "shall be taxable only in that State".

Therefore, if an individual receives a pension from a contracting state for services rendered to that state but the individual is a resident and national of the other state, only this other state has the right to tax the amounts.

There might also be an exclusion through a residual rule, albeit being within the same article. This is the case of article 13(5), which further continues to exclude the source state's taxation rights by providing that gains deriving from the alienation of property that has not been dealt with the previous paragraphs "shall be taxable only in the Contracting State of which the alienator is a resident". The article therefore begins by specifying distributive rules but then has a residual provision in order to include and discipline any other possible factual occurrence.

#### 1.4.2. Limited taxation rights of the source state

In addition to providing a total limitation of rights of the source state, there are also articles or parts of articles in the model conventions that limit taxation rights. Typically, such a limitation will be expressed in a percentage of a base that will constitute the grounds of justification of the use of tax sovereignty.

There are a few articles that limit the source state's taxation rights, including article 10 and article 11. Article 10(2) introduces a withholding tax that is of a limited amount (5% or 15%), while 11(2) instead stipulates that if the "beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest". As can be noted, they mainly consist of a percentage up to which the source state may be able to tax.

#### 1.4.3. Unlimited taxation rights of the source state

When addressing unlimited taxation rights that are allocated to the source state, it should be noted that there are also a number of applicable provisions. There are also a variety of ways through which this is granted. Articles 6, 13(1), 13(2), 13(4), 16 and 17 state that the source state "may" tax the class of income identified. Article 7(1) indicates that those profits that are attributable under the convention to the PE "may be taxed" in the PE's state. There are, however, other ways with which it is possible for the model to assign unlimited taxing rights to the source state or limit such power. One example of this is article 15(1), which has an identical



structure to article 7(1) as mentioned above. The second part of the first period ensures the impossibility of the source state to tax by stating “unless the employment is exercised”. The second sentence in paragraph 15(1) then specifies under which condition this right is not *exclusive*.

#### 1.4.4. Exclusion of taxation rights in the residence state

Since double tax treaties originally grant the residence state taxing rights, the exclusion of such rights must be exceptions to the general rule or exceptions to the exception. There are only two instances in which the exclusion of taxation rights in the residence state occur in the distributive rules of the OECD Model. In particular, the exclusion of rights of the residence state can only be found in article 19(1)(a) and 19(2)(a), which provide that “[s]alaries, wages and other similar remuneration” and pensions and similar items of income “shall be taxable only in that State” that has paid the amounts. It should be noted that there will always be an unlimited right to tax for the source state if taxation rights are excluded in the residence state.

### 1.5. The concepts behind distributive rules

#### 1.5.1. Principle of universality<sup>26</sup>

The first element to clarify is the principle behind the way that tax treaties are structured with regard to distributive rules. As will have been noted, they collectively allocate taxing power of all possible classes of income that fall within the scope of a tax treaty. Whenever articles 1 and 2 are met, there is one distributive rule that applies to the facts of the matter. Stated differently, distributive rules are meant to cover the “universality” of the classes of income within the operation of the relevant tax treaty. In the absence of specific provisions, article 21(1) or 21(3) will apply. In this context, it might also be stated that the approach of tax treaties is *comprehensive*. In particular, the scope of article 21(1) must therefore be determined *by exclusion*,<sup>27</sup> and it particularly includes third pillar pensions, unemployment benefits and

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26. “The quality or state of being universal” (Merriam-Webster online, available at <https://www.merriam-webster.com/dictionary/universality>), intending with this the “inclusion of all (or most) individuals, cases, or instances”. The Oxford English Dictionary, *Universality*, n. 2.a.

27. A. Rust, *Article 21 – Other Income*, in *Klaus Vogel on Double Taxation Conventions* m.no. 29, p. 1542 (4th ed., A. Rust & E. Reimer eds., Wolters Kluwer Law & Business 2015).

possibly alimony payments, in addition to punitive damages and payments under non-competition covenants.<sup>28</sup> Article 21(1), however, is more fundamentally important to alleviate deficiencies created by distributive rules, such as articles 6, 10, 11 and 12, that address income arising in the other contracting state and not a residence state or a third state.<sup>29</sup> The scope of application is, in fact, so broad that it includes items of income “wherever arising”.<sup>30</sup> An exception to the rule of article 21(1) is provided in the UN Model, which reads: “Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.” The resident state would then lack exclusive taxing rights and be required to grant relief under article 23.

### 1.5.2. Rules needing a cross-border connection to apply

There are many norms that need a cross-border connection to apply *in addition to residence*. Article 6 requires that property is located in the other state that is not that of the resident.<sup>31</sup> For the article to apply, there must be immovable property in State A while the residence of the person deriving income from said property must be in the other contracting state, e.g. State B. Another set of such articles are articles 10, 11 and 12, which need a cross-border element to operate, as there is the need for a cross-border relationship to occur where the beneficiary is a resident of the other state. For example, the general principle of article 10(1) “[d]ividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State” entails that there must be a company resident in one state (for example, State A) and a person residing in another country, State B. In such a case, the article would be applicable. However, if both residents were residents of State A, then the article could not apply because the factual background falls outside the scope of the article.

However, when distributive rules do not require cross-border activity, they will be applicable through residence only as is the case of article 7(1). The article simply establishes, as noted above, that the residence state has the exclusive right to tax if no PE is present in the source state. This implies that the resident state will have the exclusive jurisdiction to tax regardless of whether there is a cross-border connection and, therefore, article 7 does not

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28. Id., at pp. 1542-1543, m.no. 29.

29. Id., at p. 1546, m.no. 32.

30. Art. 21(1) *OECD Model*.

31. Lang, *supra* n. 4, at m.nos. 8 and 9.

need one to apply; this is always applicable in any case. Similarly, articles 8, 15, 18 and 21(1) also do not need a cross-border connection to apply.

### 1.5.3. Avoiding overlaps through explicit priority rules

There are also different articles, as mentioned previously, that contain “explicit” priority rules. These are rules for which interpretation is not necessary since the norm is sufficiently clear and expressed.<sup>32</sup> The first are general rules of priority. This is the case of article 7(4), “[w]here profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article”. It provides a general rule of priority with regards to the application of the more specific distributive rule. This makes it a general rule of priority because it provides a broad rule that applies to different cases. For the same reason, another rule of general priority is article 21(1) since it also refers to a multiplicity of possible situations.<sup>33</sup>

Another group that contrasts in its way of operation to the one previously described is that of special priority rules between articles. This is the case of article 15(1) mentioned above, which is superseded by articles 16, 18 and 19. Article 17 then inherently imposes its priority over article 15. Article 18 then makes its provisions “[s]ubject to the provisions of paragraph 2 of article 19”. Article 19, in turn, makes articles 15 to 18 apply in the event that a contracting state, one of its political subdivisions or a local authority carries on a business that remunerates its services with wages, salaries, pensions and similar types of remunerations.

There are other articles, such as article 19(1)(b), 19(2)(a) and 19(2)(b), that give priority rules between distributive rules in the same article. In particular, article 19(2)(a) begins by stating “notwithstanding the provisions of paragraph 1”; thus, the matters disciplined therein will be treated differently and give priority to the other part of the sentence in the paragraph. This means that the priority rule will apply to a given part of the article in certain conditions restricting the application of the distributive rule in favour of another.

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32. At least from the point of view of the author. Compare with S. Castagna, *Inherent and Implied Powers of International Arbitral Tribunals: Characteristics and Limits*, 82 *Arbitration: Int'l J. Arb., Med. & Disp. Manag.* 4 (2016).

33. The article, in fact, reads: “Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.”

#### 1.5.4. Avoiding overlaps through interpretation

Many conflicts between distributive rules occur as they must be applied through interpretation *necessarily* because there are no explicit priorities given. In this context, the drafters of the models may have left open-ended issues either willingly (for the lack of a possible solution at the negotiation table) or unwillingly because of vacuums that are unexpected. One matter of relevance is the relationship between articles 7 and 15 that depends on the understanding of the term “employment”, especially in the context in which a partner in a partnership that has an employment contract with it (for example, as a manager).<sup>34</sup> Interpretation is therefore required to understand which article to apply and whether to treat the income as deriving from employment or as income from independent activities.

### 1.6. The different types of distributive rules

#### 1.6.1. Business income

As the title of the OECD Model states, double tax treaties deal with income and capital. In particular, business capital takes the lead in terms of the number of distributive rules that exclusively address business income. The first is because it is within its nature and scope to address only business income, and the second is due to its scope being limited to only that of “[p]rofits of an enterprise”.<sup>35</sup> Article 13(2) instead relates to income for which one resident has a PE in the source state, and it can be imagined that this possibility can only occur in the presence of a business activity. The further two articles, 13(3) and 22(3), exclusively pertain to the taxation of capital gains or capital of enterprises. Additionally, article 17 likely refers to only business income.

#### 1.6.2. Non-business income

There are more articles that wholly address income that can only be derived by individuals than those that can exclusively refer to companies or business activities. These are articles 15, 18 and 19. Only human beings, for now,

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34. E. Reimer, *Article 7 – Business Profits*, in *Klaus Vogel on Double Taxation Conventions* m.no. 40, p. 508 (4th ed., A. Rust & E. Reimer eds., Wolters Kluwer Law & Business 2015).

35. *OECD Model: Commentary on Article 8* (2017).

can receive a salary, wage or pension for services. It has to be further added that the fundamental essence is not necessarily that these articles address income that only a person might obtain but also that only a natural person not carrying out business activities can gain; employment cannot per se be considered as business activity. The same can be stated for the other activities/type of income addressed here.

### 1.6.3. Dual type income

There are also provisions that can address both business income and income that can be earned through the private activity of a person, such as a loan, a small investment in a company or a portfolio of companies. These are a less popular, albeit important, set of articles and provisions. One example is article 6 since income from immovable property may be generated by both private individuals and within the context of the operation of a business. Income from immovable property can be created by a rent paid through a commercial lease between companies, and it could also be derived by a private individual occasionally renting out property just as a favour to a friend. Another example is article 10(1) in relation to dividends that can be the fruit of personal investments in addition to investments as part of a business operation. Article 11(1) is also an additional example since interest can also be owed for personal loans and article 12 if royalties are not to be classified as business income.

## 1.7. Conclusions

In the conclusion of this chapter, it would be helpful to underline that the complexity of the international economy poses challenges to the application of such a comprehensive and detailed legal framework constituted by the distributive rules, notwithstanding the clear and fundamental principles on which they develop. There are still many issues and matters that have been left unaddressed that have high practical relevance and those that the drafters of the models have not expressly addressed. After the prior analysis, it should be noted that the role and relationship of distributive rules constitute the heart and core of international tax treaties. They are the fundamental pillars upon which modern economies operate from a tax perspective. Changes to this ecosystem, which has been nurtured throughout the past century, have to be well thought through but must be made in light of the above highlighted gaps and the everyday needs of a complex society where important and complex transactions must be decided in a relatively brief amount of time.







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