Michael Lang

Introduction to the Law of Double Taxation Conventions

2nd edition

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Introduction to the Law of Double Taxation Conventions 2nd edition

Why this book?
Cross-border activities or transactions may trigger tax liability in two or more jurisdictions. In order to mitigate the financial burden resulting from these situations, states have entered into numerous double taxation conventions, which provide for rules that allocate the taxing rights between the contracting states.

This book provides an introduction to the law of double taxation conventions. Although principally aimed at students, the book will be of value to tax experts, wishing to gain a better understanding of double taxation conventions, as well as international law experts, seeking to increase their knowledge of tax law. Through examples from different countries and their jurisdictions, the book gives a truly global overview. The problem of double taxation, the state practice in the conclusion of DTCs and their effects, the interpretation of double taxation conventions and treaty abuse are also discussed in detail. Finally, the book analyses all provisions of the OECD and UN Model Tax Conventions on Income and on Capital and the OECD Model Convention on Estate, Inheritance and Gift Tax.

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6. The structure and system of DTCs

6.1. Applying the convention

The structures and systems of all DTCs show similarities. Tax treaties usually contain rules relating to the personal and substantive scope. The allocation of taxing rights over the persons and taxes covered is dealt with in one of the allocation rules. The avoidance of double taxation is almost always dealt with in the method article. Other provisions supplement the treaties.

Insofar as the treaty follows the OECD Model, the personal scope of a DTC is established by Art. 1 and Art. 4 (cf. m.no. 182 et seq.). Under Art. 1 OECD Model, the convention is applicable to persons who are residents of one or both contracting states. According to Art 3(1) OECD Model, a person includes an individual, a company and any other body of persons. However, a PE is not regarded as being a person. Under Art. 4(1) OECD Model, any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, is considered a “resident of a Contracting State”. Persons who are liable to tax in that state in respect only of income from sources in that state or capital situated therein are not considered “residents of a Contracting State”. It is inferred from this article that worldwide tax liability in one of the two states is a condition for the application of the DTC.

The substantive scope is established by Art. 2 (cf. m.no. 225 et seq.). Art. 2(1) OECD Model states that the convention shall apply to taxes on income and on capital imposed on behalf of a contracting state or of its political subdivisions or local authorities, irrespective of the manner in which they are levied. Usually, Art. 2 also lists the taxes in force at the time the treaty is concluded, which fall into the substantive scope of the treaty, and establishes that the convention is applicable to any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes.

If the convention is applicable to both the person and the taxes, the allocation rules must be applied (cf. m.no. 233 et seq.). With respect to the taxation of income, the allocation rules can be found in Art. 6 to Art. 21 OECD Model (with the exceptions of Art. 9). With respect to the taxation of capital, the allocation rules are set out in Art. 22 OECD Model. The legal consequences of the allocation rules differ: some allocation rules reduce source taxation; others entirely remove the taxing rights of the source state. The restriction of taxing rights of the residence state is not generally found in an allocation rule but rather in the method article.

The method article (Art. 23 OECD Model) contained in DTCs provides the manner in which double taxation will be eliminated (cf. m.no. 405 et seq.): either the exemption method or the credit method will be applied. The exemption method interferes with the taxable base, so that certain income or assets become tax exempt. The credit method obliges the residence state to credit the taxes levied by the source state in accordance with the allocation rules.
6. The structure and system of DTCs

6.2. Persons covered

DTC provisions that reproduce Art. 1, Art. 3 and Art. 4 OECD Model cause the DTC to be applicable if worldwide tax liability exists in at least one of the two states. Consequently, the law of the contracting states is decisive in this respect. In the case of worldwide tax liability in one of the two states, the other contracting state is obliged to apply the DTC.

DTCs are applicable even if worldwide tax liability exists in both states. In this case, a choice between the two contracting states must be made in order to determine the residence state for tax treaty purposes, since the functioning of the allocation rules and the method article requires that there is only one residence state. Insofar as individuals are concerned, the criteria under which the residence state is established are found in Art. 4(2) OECD Model (cf. m.no. 208 et seq.). Permanent home, centre of vital interests, habitual abode and nationality arise in sequence. As far as persons other than individuals are concerned, the criterion to determine the residence state is found in Art. 4(3) OECD Model (cf. m.no. 222 et seq.). The place of effective management is decisive. In the UN Model, apart from the place of effective management, the place of incorporation is mentioned as an additional criterion in Art. 4(1). However, in accordance with the OECD Model, Art. 4(3) UN Model states that ultimately the place of effective management shall be decisive for determining the residence state.

The determination of the residence state is for treaty purposes only. The residence in just one of the two states does not automatically mean that in the other state taxes are levied under the limited tax liability rules. Domestic full tax liability rules of the source state may remain applicable. The amount of tax might still be determined according to the residence taxation rules and not according to non-residence taxation rules.

The DTC signed between two states, however, is not applicable in cases of limited tax liability in both states. In these cases, a taxable person can only rely on DTCs potentially existing between the states in which he/she/it is subject to limited taxation and the state where he/she/it is subject to full tax liability. If such DTCs do not exist, double taxation can only be avoided by unilateral measures.

Example

An individual is resident in Switzerland. She receives dividends from a corporation incorporated in France with its place of effective management in the Netherlands. Both France and the Netherlands tax the dividends paid to the individual. However, the France–Netherlands DTC does not apply since the individual is subject only to limited tax liability in both states. Double taxation can only be avoided by the application of the France–Switzerland DTC and the Netherlands–Switzerland DTC.
6.3. Taxes covered

Pursuant to DTC provisions that reproduce Art. 2(1) OECD Model, the treaty is applicable with respect to **taxes on income** imposed on behalf of a contracting state or its political subdivisions or local authorities. The manner in which they are levied is irrelevant. In general, taxes imposed on total income or on elements of income are covered. In addition, Art. 2 OECD Model sets out a list of the taxes in force at the time the treaty was concluded to which the DTC shall apply. An adjustment clause usually supplements this provision. Pursuant to this clause, the OECD Model is also applicable to any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes.

Pursuant to DTC provisions patterned after Art. 2 OECD Model, the treaty is also applicable to **taxes on capital** imposed on behalf of a contracting state or its political subdivisions or local authorities. As with taxes on income, the manner in which taxes on capital are levied is irrelevant. In general, taxes imposed on total capital or on elements of capital are covered. When taxes on capital are included in the substantive scope of a DTC, the treaty can still have an impact when those taxes have been abolished in the domestic law of one of the contracting states: as long as the other contracting state keeps levying taxes on capital, the treaty benefits are available to taxable persons despite the fact that the former state has waived levying taxes of that kind.

6.4. Allocation rules

The allocation rules of DTCs (patterned after Art. 6 to 8 and 10 to 21 and Art. 22 OECD Model) shall apply only if the personal and substantive scope of the treaty are fulfilled. Thus, the personal and substantive scope must first be examined. In most cases, the allocation rules do **not ensure that double taxation is avoided**. The limitation of the taxing rights of the residence state is provided for in the method article.

**Example**

Pursuant to Art. 7(1) of the Italy–Spain DTC, business profits of an enterprise of a contracting state are taxable in the other contracting state if the enterprise carries on business in that other state through a PE. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to that PE. The profits that an Italian company makes through its PE in Spain can therefore be taxed in Spain. This does not mean, however, that Italy cannot tax these business profits. Art. 7(1) does not address Italy’s right to tax. The method article (Art. 22 Italy–Spain DTC) does not deprive Italy of its right to tax but rather provides that Italy will credit the tax paid to Spain on the business profits.
The allocation rules impose **limitations on the taxing rights of the source state.** This is frequently the case with dividends, interest and royalties. The allocation rules often state that the source state’s tax cannot exceed a certain rate. The avoidance of the remaining double taxation is dealt with in the method article.

**Example**

Under Art. 10(1) of the Australia–Japan DTC, dividends paid by a company that is a resident of a contracting state to a resident of the other contracting state may be taxed in that other contracting state. Australia may therefore tax dividends received by an Australian resident from a Japanese company. Japan’s taxing right is not restricted by this provision. Art. 10(2) Australia–Japan DTC provides that the dividends may also be taxed in the contracting state of which the company paying the dividends is a resident but the tax cannot exceed 10% of the gross amount of the dividends. Thus, Japan’s right to tax is restricted to 10%. The double taxation of this 10% is avoided through the method article (Art. 25 Australia–Japan DTC), which provides that Australia will give a credit for the tax paid to Japan.

In some cases, however, the allocation rule **excludes the taxing rights** of one of the two states entirely. This is usually the case when the allocation rules state that certain income “shall be taxable only” in the other state. In this case, the former state no longer has any taxing rights.

**Example**

Pursuant to Art. 9 of the Belarus–Denmark DTC (interest article), interest arising in a contracting state and paid to a resident of the other contracting state shall be taxable only in that other state. Thus, interest arising in Denmark and paid to a resident of Belarus can only be taxed in Belarus.

All items of income are to be assigned to one single allocation rule. In cases in which none of the allocation rules established in Art. 6 to Art. 8 and Art. 10 to Art. 20 OECD Model applies, the **blanket clause** in Art. 21 OECD Model (other income) is applicable: all items of income not dealt with in the foregoing articles of the DTC are covered by this clause. Art. 22(4) OECD Model regarding taxes on capital has a similar function. Nearly all DTCs include such other income provisions as foreseen by the OECD Model. However, the treaty network of Jersey shows that these provisions are not necessarily to be found in a DTC: only a few treaties (e.g. those signed with Estonia, Hong Kong, Ireland and Malta) include a blanket clause along the lines of Art. 21 OECD Model. In the absence of such a rule domestic taxation may arise because not all sources of income are covered by the allocation rules. Still, this type of convention remains an exception.

**Example**

Dividends are covered by Art. 10 OECD Model. The provision applies only to dividends arising in a contracting state and paid to an individual resident in
6. The structure and system of DTCs

the other contracting state. Thus, dividends received by a resident of Belgium from a company resident in Belgium or in a third country are not covered by Art. 10 OECD Model. In such a case, Art. 21 OECD Model applies. This rule gives the exclusive right to tax to the residence state and prevents the other contracting state from levying a tax on these dividends.

176 Each item of income or element of capital can only be covered by one allocation rule, not by several. The application of the method article presupposes that only one allocation rule is applicable. Should two or more allocation rules receive consideration, it is essential to clarify through interpretation which allocation rule is to be applied. In some cases the allocation rules contain express priority provisions. If this is the case, these treaty provisions state which allocation rule is to be given priority in the conflict.

177 Example

A Dutch company receives dividends from Iceland. Under Art. 7 of the Iceland–Netherlands DTC, the profits of the Dutch company cannot be taxed by Iceland unless the Dutch company has a PE in Iceland. Dividends, however, are covered by Art. 10 Art. 7(7) of the applicable treaty provides that where profits include items of income which are dealt with separately in other articles, the provisions of those articles shall not be affected by the provisions of Art. 7. Thus, Art. 7 provides that Art. 10 Iceland–Netherlands DTC is to be given priority and Iceland will be entitled to levy source taxation on the dividends.

6.5. Methods for elimination of double taxation

178 Generally, in the allocation rules, the taxing rights of one of the two contracting states are partially restricted. Therefore, the manner in which double taxation is avoided is set out in the method article. In continental Europe, the exemption method is often adopted: the residence state excludes from the taxable base the income derived or the capital owned in the other state. In this case, the taxing rights lie only with the source state. The residence state may nevertheless take the exempt income or capital into account in calculating the amount of tax on the remaining income or capital of the taxable person. This proviso safeguarding progression ensures the mitigation of the advantages that are created through the allocation of income to different states and the corresponding classification of income into low-tax brackets in both states.

179 Example

A Belgian entrepreneur has a place of business in Brussels and another in Amsterdam. In each place of business, he earns business profits of EUR 30,000. Pursuant to Art. 7(1) of the Belgium-Netherlands DTC, the business profits earned in Amsterdam may be taxed by the Netherlands. Art. 23(1) of
that DTC precludes Belgium’s right to tax these profits, but the DTC also allows these profits to be taken into account in determining the tax due on the remaining income. Consequently, only the income of EUR 30,000 in Belgium is subject to tax in this state but the applicable rate of tax is the one that would be applied to income of EUR 60,000.

The second method is the credit method. It is especially common for countries belonging to the Anglo-American legal system. It is also adopted in almost all DTCs to avoid double taxation on dividends and interest and, in some DTCs, to avoid double taxation on royalties. Under the credit method, the taxable base in the residence state remains unchanged. In other words, the foreign income is still included in the domestic taxable base. However, the taxes levied in the source state are credited on the taxes levied in the residence state.

**Example**

A Maltese corporation receives dividends of EUR 10,000 from a 5% holding in an Irish corporation. Pursuant to Art. 10(1) Ireland–Malta DTC, Malta may tax these dividends. Under Art. 10(2), Ireland may also tax the dividends to a maximum of 15%. Under Art. 22(2), Malta will give a credit for Irish tax at source. In Malta, the EUR 10,000 are subject to corporate tax of 35%, and tax of EUR 3,500 is payable. The Irish tax at source amounts to EUR 1,500, which is credited on the Maltese tax due such that it amounts to EUR 2,000.
7. Persons covered

7.1. Full tax liability as a prerequisite for the application of the DTCs

7.1.1. Full tax liability

Pursuant to treaty provisions patterned after Art. 1 OECD Model, DTCs are applicable to persons who are residents of one or both contracting states. Art. 4 OECD Model serves as a basis for treaty provisions defining the concept of residence. Under these provisions, a resident is “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.” In practice, this wording indicates that full tax liability in one of the two contracting states leads to treaty entitlement.

Example
A corporation is established in the Netherlands and is subject to full tax liability therein. It derives income almost exclusively from Dutch sources but it also holds an 11% participation in a Japanese company from which it receives dividends. With respect to those dividends, the Dutch company benefits from the participation exemption regime, according to which the dividends are fully excluded from the taxable base. Therefore, the Dutch company is subject to taxation only on Dutch-source income. Nevertheless, the Dutch company is a resident of the Netherlands under the DTC between Japan and the Netherlands so that the DTC is applicable. In fact, full tax liability in the Netherlands is sufficient for these purposes. Therefore, the Dutch company can also benefit from the reduction of Japanese taxation at source on the dividends according to the provisions on dividends included in the DTC between Japan and the Netherlands.

Any taxable person who is liable to tax in one of the two contracting states by reason of his domicile, residence, place of management “or any other criterion of a similar nature” is entitled to treaty benefits. The meaning to be attributed to “similar” is controversial. According to one opinion, every characteristic which leads to full tax liability is similar (cf. Huemer, Steuerpflicht, 99 with further references). According to another view, the characteristics mentioned in Art. 4(1) OECD Model are locality-related; hence, it is crucial that the “criterion of a similar nature” also is a locality-related criterion (Vogel, DTC Art. 4, m.no. 29).

Example
In some countries, persons are deemed to be residents by other criteria, even though they have no physical home or location in the state. In the United
States, for example, nationality attracts full tax liability. Some DTCs include these additional criteria in Art. 4(1) (Vogel, DTC Art. 4, m.no. 30). If the DTC does not, however, include these additional criteria, deemed residents of the state who are resident in third countries may or may not be entitled to treaty benefits of DTCs concluded by that state. If a court believes that the term “other criterion of a similar nature” refers only to characteristics of a locality-related nature, a deemed resident of the state who is resident in State A will not be entitled to benefits of DTCs concluded between State A and the state of the deemed residence. If, on the other hand, the court is of the view that the phrase refers to every characteristic which leads to full tax liability, the deemed resident will be entitled to the benefits of the DTC concluded between State A and the state of the deemed residence.

7.1.2. Effects of the DTC non-discrimination rules

According to some opinions, the non-discrimination rules usually included in DTCs can lead to treaty entitlement of persons who are not residents of a contracting state (cf. e.g. Jirousek, ÖStZ 1999, 607). In particular, the **non-discrimination rules regarding PEs** through which non-residents carry on their activities are sometimes interpreted as allowing these non-residents tax treaty benefits in the PE state under DTCs concluded between the PE state and other states. However, the OECD Commentary on Art. 24 (at para. 69 et seq.) takes a different view: a PE of a company that is not resident in one of the contracting states and which receives e.g. dividend payments arising in a contracting state, shall therefore not be granted treaty benefits (and not be given a tax credit). Double taxation arising from this situation can be avoided by domestic provisions or supplementary DTC rules, which are bilaterally negotiated.

In my view, a distinction has to to be made: There is no reason why the non-discrimination clause should not be applicable in this situation. If no tax credit is granted, the foreign enterprise with its domestic PE would be discriminated against as compared to a domestic entrepreneur. However, that does not mean that the treaty becomes applicable. The PE state is only obliged to extend the benefits granted under the treaty to PEs of foreign enterprises. Since the treaty does not become applicable, there are no effects in the state where the dividends are arising.

**Example**

A company resident in Switzerland has a PE in France. Interest from Hungarian sources is attributable to this PE. The France–Hungary DTC is inapplicable since the Swiss company is not a resident of either contracting state. However, Art. 26(3) of the France–Switzerland DTC (non-discrimination) provides that the taxation of a PE, which an enterprise from Switzerland has in France, shall not be less favourably treated in France than the taxation levied on enterprises of France carrying on the same activities. According to the
view mentioned above, France must treat the PE of the Swiss company no less favourably than it would treat PEs of French enterprises. In taxing the business profits of the PE, France must therefore allow the PE a credit for the tax paid to Hungary.

7.1.3. Effects of other DTCs

Under international law, the relationship between third states and treaties is defined by the general formula *pacta tertiis nec nocent nec prosunt*: a treaty only creates law between states which are parties to it; neither rights nor obligations can be created by it with regard to third states. This general principle is codified in Art. 34 VCLT.

Nevertheless, the applicability of a certain DTC might be influenced by a DTC concluded by one contracting state with another state. This might occur because of the *residence tiebreaker rules* which are contained in the latter DTC (cf. e.g. the IRS Revenue Ruling 2004-76). Grounds for this interpretation are found in the second sentence of Art. 4(1) OECD Model, according to which the term “resident of a Contracting State” “does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein”. In fact, due to the 2008 amendments to the OECD Model, the Commentary on Art. 4 OECD Model (at para. 8.2) now reads as follows: “According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State … companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State’s tax law, are considered to be residents of another State pursuant to a treaty between these two States”. Such an interpretation, however, is questionable from a legal standpoint (cf. also Vann, in Maisto (ed.), *Residence of Companies*, 252 et seq.)

Example

* A company is incorporated under the law of State A and has its place of effective management in State B ("Company AB"). Company AB is a resident of both states under domestic law. The company owns a 51% participation in a company which is a resident of State C ("Company C"). There is no DTC between State B and State C, while an OECD-patterned DTC exists between State A and State C and between State A and State B. Under State C’s domestic law, a 30% withholding tax applies to outbound dividends. In 2010, dividends are paid by Company C to Company AB. State C does not grant a reduction in withholding tax as set out in the A–C DTC (5%). According to State C, company AB cannot claim the benefits of the A–C DTC since it is not a resident of State A under Art. 4(1) of the A–C DTC. This would be due to the fact that, notwithstanding that Company AB is a resident of State A under domestic law, it
is not considered to be a resident of State A under the A–B DTC. This conclusion, however, is questionable from a legal standpoint.

7.2. Treaty entitlement of corporate entities that are subject to limited tax liability

7.2.1. Public law corporations

It has occasionally been questioned whether public law corporations that are subject to limited tax liability are entitled to treaty benefits. Vogel correctly points out that the condition for tax treaty entitlement is not that the person be actually taxed without restriction but that the person merely shows those connections to the contracting state that can lead to full tax liability (Vogel, DTC Art. 4, m.no. 24 et seq.). Therefore, states and their political subdivisions or local authorities are also entitled to treaty benefits.

Example

A Dutch municipality holds shares in a Swiss corporation. The dividends received from this participation are not received in connection with a business carried on by the municipality. The Dutch municipality is nevertheless entitled to the 15% withholding tax rate provided by Art. 10(2) of the Netherlands–Switzerland DTC.

In 1995, the OECD Committee on Fiscal Affairs changed Art. 4(1) OECD Model in this respect, expressly including states and their political subdivisions or local authorities among persons entitled to treaty benefits. It is doubtful, however, whether public law corporations that are not at the same time political subdivisions or local authorities are entitled to treaty benefits. Since the OECD Committee on Fiscal Affairs merely mentioned states and their political subdivisions or local authorities, it could be argued that the reverse conclusion is applicable to public law corporations, i.e. that public law corporations do not have any tax treaty entitlement. However, the intention of the OECD Committee on Fiscal Affairs was obviously not to go in this direction and such reverse conclusion shall not be drawn.

Example

A Jesuit order is a public entity according to German domestic law. The order runs a school of philosophy. From that activity, it generates royalty income from Italy and Spain. These payments are taxable in Germany under German domestic law notwithstanding the fact that the Jesuit order is generally subject to limited tax liability in Germany. The Italian and Spanish tax at source has to be reduced to 5% pursuant to Art. 12(1) and (2) of the DTCs between Germany and Italy and Germany and Spain (GE, FG München, 13 Jun. 2003, 7 K 3871/00). In my opinion, despite the 1995 amendments to the OECD Model, this conclusion is still correct.
7. Persons covered

7.2.2. Corporate entities that are exempt from full tax liability

Corporate entities that are exempt from full tax liability are also regarded as being entitled to tax treaty benefits. The same considerations that apply to public law corporations apply to these corporations. The fact that these exempt corporations are not expressly mentioned in Art. 4(1) OECD Model, in contrast to states and their political subdivisions or local authorities, does not alter this conclusion.

Example
In SE, Regeringsrätten 2 Oct. 1996, RÅ 1996 ref 84 (6301-1994), a Swedish company held a 100% share in a Luxembourg fund. Under Luxembourg law, the fund was exempt from corporate tax and any other tax covered by the Luxembourg–Sweden DTC. When the fund distributed profits to the parent company in Sweden, the question was whether the DTC was applicable. In particular, was the fund resident in terms of Art. 4(1) of the Luxembourg–Sweden DTC and were the dividend payments therefore covered by Art. 10 of the treaty? The Swedish Supreme Administrative Court held that the DTC was applicable to the situation at hand. The Court interpreted the phrase “liable to tax”, which is a prerequisite for being resident in terms of Art. 4(1), as a requirement of formally being subject to unlimited tax liability. It was not necessary that the person actually has paid tax. Consequently, when the profits of the funds were distributed as dividends, the domestic exemption provisions and Art. 22(2)(b) of the Luxembourg–Sweden DTC applied and the result was double non-taxation.

7.3. Treaty entitlement of partnerships and/or partners

Partnerships are “persons”. This is because Art. 3(1)(a) OECD Model states that the term “person” includes individuals, companies and any other body of persons. Under Art. 3(1)(b) OECD Model, the term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes. However, in order to be entitled to tax treaty benefits, such a person must also be a resident of one or both of the two contracting states under Art. 4(1) OECD Model. Accordingly, a person has to be “liable to tax”. Thus, liability to tax in one of the two contracting states is a condition of treaty entitlement.

According to prevailing opinion, partnerships are not entitled to tax treaty benefits if they are not tax subjects for income tax purposes. The application of the tax treaty is therefore obtained “through” partnerships. Consequently, the person entitled to tax treaty benefits is not the partnership but rather the partner(s).

Example
An Italian partnership has three partners and a place of business in Spain. One partner is resident in Germany, another in Switzerland and the third in Italy.
With respect to the Italian partner’s income, the Italy–Spain DTC applies; with respect to the Swiss partner’s income, the Spain–Switzerland DTC applies; with respect to the German partner’s income, the Germany–Spain DTC applies.

The above conclusion, however, is controversial if a partnership is characterized in different ways in two states, e.g. if it is characterized as a taxable entity in one state and is treated as transparent for tax purposes in the other state. The OECD Committee on Fiscal Affairs created a Working Party that produced a report on this topic. The OECD’s position makes the tax treaty entitlement in the source state dependent on the tax treatment of the partnership in the state in which it is established: if the partnership is treated as a tax subject in the latter state, it should be entitled to treaty benefits, otherwise the partners should be entitled to tax treaty benefits if they are resident there (cf. OECD Partnership Report). However, more convincing arguments suggest the focus should be put on the tax treatment in the source state (cf. Lang, Partnerships, 31 et seq). Therefore, partnerships which are characterized as taxable persons by the source state should also be entitled to tax treaty benefits there. If they show close connections to a state that is a DTC partner, which would normally lead to full tax liability, the relevant DTC should be applicable.

Example

A partnership with a head office in State P receives dividends from a company resident in State S. The partners of the partnership are resident in State R. States S and R treat the partnership as a taxable entity while State P treats it as transparent. According to the opinion set out in the OECD Partnership Report, the P–S DTC is not applicable because the partnership is not a resident of State P since State P treats it as transparent. The partners are resident in State R but since State R considers the income to be received by the partnership and not the partners, the R–S DTC cannot apply. The tax in State S is therefore not restricted since neither DTC applies. If, however, the characterization in the source state were followed, the P–S DTC could apply. Admittedly, the partnership is not resident in State P; however, the necessary connection for purposes of residency (head office) exists in P.

Some DTCs contain special provisions for partnerships. These DTCs set out the conditions under which the partner(s) are entitled to tax treaty benefits. For example, many DTCs concluded by the United States include a provision which codifies the OECD approach. Under that provision: “An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident”. Moreover, in some DTCs, it is sometimes stated that, under certain conditions, partnerships are entitled to tax
treaty benefits. For example, under Art. 28(6) of the DTC between Austria and Switzerland, partnerships (general partnerships, collective companies, limited partnerships), which are established under the law of a contracting state and which have their seat in that state, “may claim the tax relief, granted in Articles 10, 11 and 12 of the Convention, from the other State, provided that at least three quarters of the profit of the association is benefitting persons who are residents of the first-mentioned State”. In recent tax treaties concluded by the Netherlands, the Protocol of the treaty contains a provision with respect to hybrid entities, which may in some cases include partnerships. The provision reads as follows: “In case an entity that is treated as a body corporate for tax purposes is liable as such to tax in a Contracting State, but the income of that entity is taxed in the other Contracting State as income of the participants in that entity, the competent authorities shall take such measures that on the one hand no double taxation remains, but on the other hand it is prevented that, merely as a result of application of the Convention, income is (partly) not subject to tax.” This provision allows the competent authorities of the Contracting States to formulate customized solutions on a case-by-case basis.

7.4. Treaty entitlement and treaty abuse

DTCs patterned after the OECD Model grant all persons that are residents of one of the two contracting states tax treaty benefits. Treaty entitlement depends only on the residence status. Further restrictions are not found in DTCs which are patterned after the OECD Model. Nevertheless, tax authorities are inclined to hold that tax treaty entitlement is not to be granted in cases, in which domestic anti-abuse provisions apply (cf. m.no. 135 et seq.), or because of an unwritten international principle of international law preventing abuse (cf. m.no. 141 et seq.). In my opinion, however, no legal basis exists for such conclusions.

Example

A Tunisian corporation receives dividends from a Norwegian corporation. Pursuant to Art. 10(1) of the Norway–Tunisian DTC, the Norwegian withholding tax rate is decreased from 25% to 20%. As long as these dividends are attributable to the Tunisian corporation, the DTC applies, even when the shareholders of the Tunisian corporation are not resident in Tunisia, but in countries with which Norway has not concluded any DTC, and therefore could not benefit from a reduction in withholding taxes. There is no legal basis for not applying the DTC.

However, in some DTCs, there are explicit rules that provide that abuse is a basis for the denial of tax treaty entitlement. These rules allow contracting states to
deny tax treaty benefits in those cases in which the entitlement to tax treaty benefits is regarded as undesirable.

**Example**

The treaty concluded between Brazil and Turkey in 2010 contains in Art. 28 a “limitation of benefits” clause, under which the competent authorities of the contracting states may deny the benefits of the treaty to any person if in their opinion the receipt of benefits would constitute an abuse of the treaty according to its purposes.

7. Persons covered

7.5. Residence state in the case of dual residence

7.5.1. Necessity of determining the residence state

7.5.1.1. Allocation rules

DTCs use the concept of “residence” for different purposes. Under Art. 1 and Art. 4(1) OECD Model, residence is a condition for the application of the tax treaty. Persons who are residents of one or both of the contracting states are regarded as being entitled to treaty benefits. For the purposes of these provisions, a person can be a resident of both contracting states. In other words, it is not necessary to award one of the two states the priority of rank.

Things are different under the allocation rules of DTCs. These rules presuppose that only one of the two states is the residence state. If both states under Art. 1 and Art. 4(1) OECD Model are regarded as residence states, a rule must exist to determine which state is the **residence state** in order for the allocation rules to apply properly.

**Example**

An individual, who is resident both of Finland and of Switzerland, receives dividends from sources in Switzerland. Pursuant to Art. 10(2) of the Finland–Switzerland DTC, the tax at source is restricted to 10%. However, the application of Art. 10 of that DTC requires that the company paying the dividends and the person receiving the dividends are residents of different contracting states. In other words, Art. 10 Finland–Switzerland DTC applies only if the application of the tiebreaker rules of Art. 4(2) of the Finland–Switzerland DTC leads to the recipient of the dividends being a resident of Finland (for the tiebreaker rules cf. in detail m.no. 213).

7.5.1.2. Method article

The same arguments apply for the purposes of the method article. This article applies to persons who are residents of a contracting state and derive income that may be taxed in the other contracting state. The differentiation from “a” and “the
other” contracting state requires that **only one of the two states be the residence state.** Otherwise, the application of the tax treaty fails.

212 **Example**

A corporation incorporated in Greece and managed in Romania receives royalties from Romania. The corporation is considered a resident of both Greece and Romania under the applicable domestic laws. Under Art. 25 of the Greece–Romania DTC (method article), the state of residence of the recipient of the royalties must grant a deduction from tax on income with respect to tax paid in the other contracting state. If Art. 25 of the DTC were applied on the basis of the domestic definition of residence, Greece would be bound to grant such a deduction for the taxes paid in Romania. However, under Art. 4(3) of the DTC, the corporation is deemed to be a resident of Romania since its place of effective management is in Romania. Since Greece is not the state of residence of the corporation under the DTC, it is not required to grant a deduction for tax paid with respect to the royalties earned in Romania.

7.5.2. **Criteria**

7.5.2.1. **Permanent home**

213 A DTC provision patterned after Art. 4(2) OECD Model provides a list of criteria for establishing, as far as individuals are concerned, how “residence” is to be determined for the purposes of the allocation rules and of the method article. These provisions are known as **“tiebreaker rules”**. The very first criterion that applies for determining residence for the purposes of the allocation rules and the method article in the case of dual residence is the permanent home. If an individual is a resident of both contracting states under Art. 4(1) he/she is resident, for treaty purposes, only in the state where he/she has a permanent home.

214 **Example**

A citizen of the United States is employed in Mexico and has an apartment there. He does not have a home in the United States. Under US domestic law, he is liable to unlimited taxation in the United States. Under Mexican rules, he is liable to unlimited taxation in Mexico as well. For the purposes of the Mexico–US DTC, however, he is deemed to be a resident of Mexico since he has a permanent home available to him in Mexico but not in the United States. However, under the saving clause contained in Art. 1(4) Mexico–US DTC, the United States retains its right to tax its citizens as if the treaty had not come into effect. Consequently, the allocation rules do not apply. Double taxation is still prevented through Art. 1(5) in connection with Art. 24(4) Mexico–US DTC, which provides special rules for US citizens resident in Mexico.
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