CHAPTER 6

TREATY RELIEF FROM JURIDICAL DOUBLE TAXATION

Introduction

We saw in Chapter 2 that countries often provide their residents with relief from juridical double taxation unilaterally through their domestic income tax law. Either in addition, or if a country does not have double tax relief provisions in its domestic law, DTAs contain articles to achieve their objective of elimination of double taxation. Therefore, in the former case, prima facie a taxpayer has two avenues through which to obtain double tax relief in respect of income taxed in a country with which his country is a DTA partner. But as we saw in Chapter 4, in the case of a conflict between the relief provisions in the domestic law and those in the DTA, the latter will prevail.

In this chapter, we will:
– distinguish between unilateral and DTA relief from double taxation;
– look at the role of Art. 23 of the OECD model DTA in eliminating juridical double taxation; and
– discuss tax sparing credit relief, and its advantages and disadvantages.

Unilateral and double tax treaty relief

Notwithstanding the obstacles that double taxation can present to the development of international economic relations, there is very limited international law constraining countries from imposing taxes outside of their borders. As a result double taxation must be dealt with domestically or unilaterally. Many countries have provisions in their domestic laws that are designed to unilaterally counter juridical double taxation. The tax credit method is the means adopted by most countries as a unilateral legislative tax relief mechanism. These measures, however, do not always combat double taxation. Since it is obviously desirable to clarify and guarantee the fiscal position of taxpayers engaged in commercial, industrial or financial activities internationally, bilateral DTAs have also been developed over time between trading nations. These DTAs formally determine which country will tax an item or taxpayer and/or whether credits will be granted for tax paid in the other jurisdiction. In doing so, most DTAs explicitly give the source country the primary right to tax but require that country to limit its tax (rate of withholding tax) on certain income (e.g. dividends, interest, royalties) and, in the case of DTAs based on the OECD model, not to tax certain types of income at all (e.g. aircraft, shipping). In this sense, the OECD model DTA severely limits the taxing powers of source jurisdictions.

In addition, double tax agreements also provide for relief from juridical double taxation. Although such relief is often already provided for in a country’s domestic tax legislation, relief via a double tax treaty may be more generous than that in the domestic law. For example, the domestic law may allow for limited relief by way of a tax deduction in the
taxpayer’s country of residence for tax paid in a foreign jurisdiction, whereas a DTA will allow for either a full exemption or a tax credit, either of which confers a greater tax benefit on the taxpayer than a deduction from assessable income.

Relief entrenched in a DTA also restricts a country’s ability to amend unilaterally the double tax relief provisions in its domestic law to the detriment of taxpayers. This could come about where, for example, the Netherlands (which, as we have seen, offers an exemption in its domestic law for foreign source income derived by its residents) enters into a DTA with Fiji, and the DTA includes the same foreign income exemption. If the Netherlands subsequently terminates the exemption by repealing its domestic law, residents of the Netherlands will continue to benefit from the exemption with respect to income derived from Fiji under the DTA exemption until the DTA provision is changed or the DTA is ended.

**Art. 23 OECD model double tax treaty**

Art. 23 of the OECD model DTA ("Methods for elimination of double taxation") offers a choice of the exemption method (Art. 23A) or the credit method (Art. 23B) of relief from double taxation.

**Art. 23A – Exemption method**

Where the exemption method is chosen, under Art. 23A(1) a taxpayer’s country of residence prima facie must exempt income or capital from tax if that income or capital *can be* taxed by the source state “in accordance with the provisions of [the] Convention”, whether or not the source state actually exercises its right to tax the item of income or capital. You should note that Art. 8(3) (Shipping, inland waterways transport and air transport), Art. 13(3) (Capital gains), Arts. 19(1)(a) and 19(2)(a) (Government service) and Art. 22(3) (Capital) state that income or capital arising under those Articles “shall be taxed only” in the source state. Therefore, such income or capital is automatically exempt from tax in the country of residence of the taxpayer under Art. 23A(1) (or Art. 23B(1) – see below).

Country R is not required to apply the exemption if Country S considers that the provisions of the DTA preclude it from taxing an item of income or capital that it would otherwise have taxed. In that case, the OECD commentary provides that Country R should, for the purposes of applying Art. 23A(1), consider that the item of income or capital may not be taxed in Country S in accordance with the provisions of the DTA, even though Country R might have applied the DTA differently so as to tax that income if it had been in the position of Country S. Thus, Country R is not required by Art. 23A(1) to exempt the item of income or capital.

To illustrate, suppose that a business is carried on through a fixed place in Country S by a partnership, which is established in Country S, and a partner, who is resident in

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1. See Chapter 10.
2. See Chapter 16.
3. See Chapter 17.
4. See Chapter 16.
Country R, alienates her interest in that partnership. Assume that Country S treats the partnership as a company whereas Country R treats it as fiscally transparent, and that Country R applies the exemption method of double tax relief. Because it treats the partnership as a corporate entity, Country S considers that the alienation of the interest in the partnership is akin to that alienation of a share in a company, which it cannot tax by reason of Art. 13(5). However, Country R considers that the alienation of the interest in the partnership should have been taxable by Country S as an alienation by the partner of the underlying assets of the business carried on by the partnership, to which Art. 13(2) or 13(3) would have applied. In determining whether it has an obligation to exempt the income under Art. 23A(1), Country R should nonetheless consider that, given the way that the provisions of the DTA apply in conjunction with the domestic law of Country S, Country S may not tax the income in accordance with the provisions of the DTA. Country R, therefore, is under no obligation to exempt the income. This result is consistent with the objectives of a DTA, one of which is to eliminate double non-taxation.

Furthermore, exemption by Country R does not apply where Country S applies a provision of the DTA to exempt the income or capital from tax (or where the income is dividends or interest subject to concessional tax rates in Country S under Art. 10(2) or 11(2)). Art. 23A(4). Again, this qualification prevents double non-taxation of the same income. This situation could arise when there is a disagreement between Country R and Country S about the facts of a case or about the interpretation of a provision of the DTA between them. For instance, Art. 23A(4) would apply when Country S interprets the facts of a case or the provisions of the DTA such that an item of income or capital falls under a provision of the DTA that eliminates its right to tax that item or limits the tax that it can impose while Country R adopts a different interpretation of the facts or the provisions of the DTA and considers that the item may be taxed in Country S in accordance with the DTA, which otherwise would lead to an obligation on Country R to give an exemption under Art. 23A(1).

Art. 23A(4) applies to the extent that Country S has applied the provisions of the DTA to exempt an item of income or capital from tax or has applied the provisions of Art. 10(2) or 11(2) to an item of income. Therefore, Art. 23A(4) does not apply where Country S considers that it may tax an item of income or capital in accordance with the provisions of the DTA but where no tax is actually payable on such income or capital under Country S’s domestic law. In such a case, Country R must exempt that item of income under Art. 23A(1) because the exemption in Country S does not result from “the application of [the] provisions of [the] Convention” but, rather, from the domestic law of Country S.

Where certain items of income (viz. dividends and interest) are subject to only limited tax in Country S – because of application of Arts. 10(2) and 11(2) of the relevant DTA, which also give Country R the right to tax that income – use by Country R of the exemption method under Art. 23A contradicts Country R’s entitlement to tax under Arts. 10 and 11 (by, in effect, requiring Country R to give up its right to tax under the latter sections). Therefore, Art. 23A(2) provides for the application of the ordinary credit method by Country R to facilitate relief from double taxation on that income, rather than solely using the exemption method.

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5. See Chapter 16.
Art. 23A(3) allows Country R to adopt the exemption with progression method of double tax relief.

**Art. 23B – Credit method**

Art. 23B(1) provides for relief from double taxation by way of the *ordinary* credit method. (The *ordinary* credit method also applies for the purposes of Art. 23A(2)). Application of Art. 23B by Country R is again dependent upon the ability of Country S to be able to tax the income or capital in question “in accordance with the provisions of [the] Convention” between Country R and Country S.

Art. 23B(1) allows a credit for income tax paid in Country S only against income tax payable in Country R and, quite separately, a credit for capital tax paid in Country S only against capital tax payable in Country R.

Practical difficulties arise with the foreign tax credit method when tax payable in Country S is not calculated in respect of the income year in which it is levied, but on the basis of a preceding year’s income or on the basis of the average income earned over a number of preceding years, and with foreign exchange rate movements between the date of payment of the tax in Country S and the date on which that tax and the income to which it relates is converted for the purposes of inclusion in the taxpayer’s assessable income in Country R. Furthermore, income on which tax may be paid in Country S may reduce a taxpayer’s net loss position in Country R without any relief for the tax paid in Country S.