A theory for resolving Qualification Conflicts in Double Taxation Treaties

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ABSTRACT

Tax treaties have a developed language of their own within the field of international law. They may include terms that are unknown in particular jurisdictions of domestic law or therein defined differently. Because the language of tax treaties and domestic law differ from each other, the definitions of certain terms and income type under a tax treaty and under different states' domestic law are not necessary identical. Despite these differences, tax treaty definitions must be used for tax treaty classification purposes, and domestic law definitions must be used for domestic law classification purposes. The tax definition determines the type of the income for tax treaty purposes even though the income would qualify under another income category under the treaty states' domestic law. Similarly, the domestic tax law definition determines the type of income for domestic law purposes (Helminen 2010). In most instances the treaty definitions of the various types of income refer back to domestic tax law, and where the domestic tax law definition deviates between the two treaty countries, this may lead to the application by these countries of different articles of the treaty. If this is caused by the application of the domestic law, this is referred to as a conflict of qualification in the Commentaries to the OECD Model Tax Convention. In general a conflict of qualification refers to a situation where identical facts are treated differently for tax purposes in different countries. Such a conflict may either concern the subject or the object of taxation.

Key words: Tax treaties, OECD MTC, Double Tax Agreements, double taxation, conflicts of qualification, hybrid entities, partnerships, fiscally transparent, domestic law, Mutual Agreement Procedures, permanent establishment.
GLOSSARY AND ABBREVIATIONS

Double taxation agreement (DTA): is an international treaty concluded between two states to determine the incidence of tax in, and the application of tax laws by, each state with the object of avoiding double taxation (Honiball & Olivier 2011).

Economic double taxation: is a situation where income or capital is taxed in two or more states during the same period in respect of the same transaction, but usually in the hands of different taxpayers (Honiball & Olivier 2011).

Fiscally transparent: "Looking through" an entity and attributing profits and losses directly to the entity's members. The profits of certain forms of enterprises are taxed in the hands of the members rather than at the level of the enterprise. Often occurs in the case of a partnership for example (OECD)

Hybrid entity: entity that is characterized differently in two or more jurisdictions, for example, an entity that is treated as a partnership in one jurisdiction and as a corporation in another (OECD).

International Tax Group: these are the founders of the theory contained in the OECD Commentary on to resolve qualification conflicts (Potgens 2012).

Juridical double taxation: a situation where income or capital is taxed in the hands of the same taxpayer more than once, whether by a way of different taxes or, in an international context, by different taxing authorities (Honiball & Olivier 2011).

Model Tax Convention (MTC): A model tax treaty is designed to streamline and achieve uniformity in the allocation of taxing right between countries in cross-border situations. Model tax treaties developed by OECD and UN are widely used and a number of countries have their own model treaties (OECD).

Mutual Agreement Procedures (MAP): a means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure described and authorized by Article 25 of the OECD MTC, can be used to eliminate double taxation that could arise from a transfer pricing adjustment (OECD).

OECD: The OECD (Organization for Economic Co-operation and Development) is a multilateral organization comprising of 30 countries, which are mostly Western European countries and other industrialized countries including US and Japan. Founded in 1961, the OECD provides a forum for representatives of countries to discuss and attempt to coordinate economic and social policies. It has an especially significant role in international tax matters. Its website is www.oecd.org.

Permanent establishment (PE): a tax treaty concept used to determine when an enterprise has sufficient connection with a country to subject it to tax on its income attributable to a PE, often incorporated into domestic law (Honiball & Olivier 2011).
NOTES

Commentary cited in this study refers to the OECD Commentary to Article 23 of the OECD Model Tax Convention, unless stated otherwise.

The following expressions ‘double tax agreement’, ‘double tax treaty’, ‘double tax convention’ and ‘tax treaty’ are used interchangeably in this study, but all refer to the OECD Model Tax Convention, unless stated otherwise.

It should be noted that that the expression ‘double taxation’ when used in this research refers to international juridical double taxation as opposed to economic double taxation, unless stated otherwise.

Article 23A and 23B are jointly referred to as Article 23 in this study.

Article 10, 11 and 12 of the OECD MTC deals with the taxation of cross-border dividends, interest and royalties respectively.
DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Sbusiso Huzlett Mabasa

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1. INTRODUCTION AND SCOPE OF STUDY

1.1. Double tax agreements

The OECD first published a Draft Double Taxation Convention on Income and Capital in 1963, followed by the MTC on Income and Capital in 1977. The OECD Model Tax Convention (OECD MTC) is accompanied by an extensive Commentary, prepared by the OECD Committee on Fiscal Affairs. Since 1992, the OECD MTC and the Commentary are updated on a regular basis (paragraphs 9-11 of Introduction to OECD MTC).

A tax treaty is a contract between two or more sovereign states. One would be referred to as a source state, whilst the other is called the residence state. Tax treaties are international agreements forming part public international law. The main objective of tax treaties is avoidance of double taxation and prevention of fiscal evasion (Gulati 2013). Furthermore, it is their goal to create legal certainty for the benefit of contracting states as well as for taxpayers and to assure the equal application of tax laws in Contracting states (Vogel & Prokisch 1993).

The importance of tax treaties has increased significantly in recent years as a consequence of the globalization of the economy and the liberalization of cross-border trade and investment. The number of bilateral tax treaties currently in force exceeds 2,500. The United Nations (UN) MTC, which caters mostly for developing countries, was revised in 2001. Despite their importance and their phenomenal growth in recent years, tax treaties are often criticized for their fundamental deficiencies (Arnold et al. 2003).

Concluding double tax agreements is a formalized way for different states to agree on a method of reducing or eliminating double taxation. Double taxation may occur for any of the following reasons: residence-residence conflict, source-resident conflict, source-source conflict and triangular conflict cases. With regard to triangular conflict cases, a country may have a source-residence conflict with one country and a source-source conflict with another country, which could trigger an incremental layer of unrecoverable taxes, unless some form of relief is provided. Most treaties are bilateral in nature and would not necessarily address triangular cases and thus one stream of income is potentially taxable in three different jurisdictions with double or triangular taxation as a result.

1.2. What is conflict of qualification?

Chapter III (Taxation of Income) and IV (Taxation of Capital) of the OECD MTC contain the operative treaty provisions. These provisions set forth the treaty object in respect of which treaty application is sought. Identifying the treaty object is of paramount importance in applying a tax treaty. First, the object must be identified under the domestic law of the contracting state whose tax to which the treaty is applied. Then the object must be identified for treaty purposes. The object, as it is identified under domestic law may be, but by no means necessarily, identical to the object identified for treaty purposes. In reality, discrepancies exist in many instances between the meaning of the term under the domestic laws of a contracting State and the meaning of the same term under the laws of the
other contracting state or under the treaty. The problem at issue is generally known as 'qualification'. Qualification is a part of a larger field of treaty interpretation (Van Weeghel 1998).

The process of qualification, in the application of a tax treaty, normally occurs twice in each instance, i.e. the source state will determine which treaty provision can be applied to the item of income in question, and the residence state will do the same. In most instances, the qualification will be the same in the source state and in the residence state, but in a quite a few instances the qualification in the source state and in the residence state may be different from each other. Van Weeghel (1998) introduces the concept of ‘positive qualification conflict’ as the situation where both states tax the same item of income as a result of the application of different provisions of the treaty. This mainly as a result of different interpretation of the treaty provisions between the states. ‘Positive qualification conflict’ therefore leads to double taxation. The reverse situation where the compensation would have gone untaxed in both states is referred to as a ‘negative qualification conflict’. Lang (2009) further explains ‘negative conflict of qualification’ as cases where, due to differences in the domestic law between the state of source and the state of residence, the former applies, with respect to a particular item of income or capital, provisions of the tax treaty that are different from those that the state of residence would have applied to the same item of income or capital, and this would give rise (if the exemption were granted) to double non-taxation.

According to paragraph 32.3 of the Commentary, a qualification conflict arises if the source and residence States apply different treaty provisions as a result of the reference to domestic law in Article 3(2) of the OECD MTC, for the interpretation of terms not defined in a tax treaty. Article 3(2) refers to the domestic law of the contracting states applying that treaty, unless the context requires a different meaning (Potgens et al. 2012).

Vogel and Prokisch (1993) further explain that in international tax law, a qualification conflict arises when a convention contains terms from domestic law that will be understood in their respective meanings by the residence or source state or that can be interpreted in an independent, “autonomous” way. Cases like this are regulated by Article 3(2) MTC if the term is used in the specific tax law of one of the contracting states which is covered by the convention. If this provision is not applicable – i.e. if the term is used in another tax law or in commercial law – or if the provision is not included in a convention, one is then faced with the question of how to proceed.

There are many situations that are not covered by the wording of tax treaties. In these situations, tax treaties cannot be applied directly. Instead, they should (if possible) be applied by analogy. The interpretation is then based on the underlying principles of the treaty and not on the wording of the treaty provisions. Conflicts of qualification also exist where tax treaties are directly applicable. In these cases, differences in the treaty application which result from a conflict of qualification could and should be prevented by a subject-to-tax clause (Helminen 2010).

Conflicts of qualification arise because of diverging tax treaty application by the contracting states. The different allocation of taxing rights may lead to double taxation or double non-taxation which can
be unfavourable for the taxpayers and tax administrations involved. The disagreement between the states may, of course, involve both the interpretation of the facts and the interpretation of the treaty provisions (Helminen 2010).

In short, there are two potential conflicts of qualification that may arise –

- Firstly, conflict of qualification arises if the source and residence states apply different treaty provisions as a result of the reference to domestic law in Article 3(2) of the OECD MTC, for the interpretation of terms not defined in a tax treaty. This is covered in the paragraph 32.4 of the Commentary; and
- Secondly, conflict of qualification can arise due to different interpretation of facts and provisions of the tax treaties, meaning where the same circumstances are qualified differently in two jurisdictions (i.e. source and residence states). This is covered in the paragraph 32.5 of the Commentary.

1.3. OECD Approach

A partial solution to the qualification problem is provided by Article 3(2) of the OECD MTC. This provision establishes the fundamental principle that each state shall apply treaty terms according to its domestic tax law for the taxes to which the treaty applies, unless the context of the treaty otherwise requires. However, Article 3(2) presumes that a corresponding concept is present in the domestic tax law of the Contracting state concerned regarding the actual taxes to which the treaty applies (Vogel 1996).

The wording of Article 23A of the OECD MTC supports the view that where an object divergence conflict occurs, the event in question is taxable in only one of the two states concerned. As the event is thus taxed in only one state, there is no threat of double taxation. Article 23A obliges the residence state to grant tax treaty relief for income that is taxable in another state. The residence state, therefore, is not obliged to grant treaty relief if the income is not taxable in the other state.

The wording, object and purpose of the OECD MTC, therefore, speak against the (direct) applicability of tax treaties in the case of an object divergence conflict. This is supported OECD’s interpretative Commentary which has, in its 2000 update, taken the position that qualification conflicts can be resolved by the proper interpretation of Article 23A. However, it is doubtful whether the wording of Article 23A, which was neither changed in 2000 nor later, expresses the meaning intended by the drafters of the 2000 update (Lang 2009).

The interpretation of the OECD (MTC and its Commentaries) only applies to conflicts arising from the application of domestic law, and not if the conflicts arise, for instance, from an interpretation of the facts or of the application of the treaty itself. In the latter cases, these problems are dealt with in terms of the mutual agreement procedure provided under Article 25 of the OECD MTC. So, if faced with conflicts of qualification, countries not being a member of the OECD, like almost all developing countries, should consider whether such interpretation is acceptable for them when applying a tax
treaty, or otherwise rely on the mutual agreement procedure to resolve any relevant problems (de Goede 2013).

It should be mentioned that conflicts of qualification have not been discussed by the UN Committee of Experts on International Cooperation in Tax Matters yet and, thus, the Commentaries to the UN MTC take no position with respect to this interpretative issue (de Goede 2013).

1.4. Distinction with conflict of classification

Before an item of income may be taxed, a determination must be made as to what type of income it constitutes under the different legal systems of international tax law. With respect to each item of income, a determination must be made as to its tax classification for purposes of domestic tax laws of the states involved, and for purposes of tax treaties. Because of the independence of these different legal systems, it is possible that the same entities and income items may be classified differently for different purposes.

A classification conflict for domestic tax purposes is the difference of opinion between contracting states as to whether a certain domestic or foreign entity is a subject that is liable to tax under domestic tax laws or whether its participants are liable to tax. It is the dispute between member states concerning which person is liable for tax. This difference of opinions may result in double taxation or double non-taxation. Therefore, in the context of “classification for tax treaty purposes” means the process of determining whether an entity is such a person liable to tax within the meaning of Article 1 of the OECD MTC (Fibbe 2009).

It is not always clear under what, if any, tax treaty income category an item of income qualifies. This uncertainty may lead to a situation where the two contracting states classify the item of income inconsistently for tax treaty purposes. Such a conflict may be referred to as a classification conflict of international tax law. This term includes both situations where the conflict leads to double taxation (i.e. a positive classification conflict) and situations where the conflict leads to double non-taxation (i.e. a negative classification conflict) (Helminen 2010).

1.5. Objects of this study

As stated above, a discussion on qualification conflicts relief is contained in Article 23 of the OECD MTC and its Commentary. This study will attempt to determine the adequacy of the solutions contained therein in relation to double tax treaties modelled on OECD MTC. This study will highlight particular far-reaching consequences of qualification conflicts, such as double taxation and double non-taxation, and then discuss the application of the proposed solutions. Simply put, the study will analyse the application of OECD MTC and its Commentaries in cases of conflicts of qualification, including the strength of Article 25 (another OECD solution to qualification conflicts), which deals with mutual agreement procedures between the contracting states’ competent authorities in the event of qualification conflict.
There has been some notable judicial decisions in the context of qualification conflicts globally. Furthermore, this study will evaluate the judicial approach to such conflicts.

1.6. **Sub-problems**

Special problems arise in interpreting treaty terms, where those terms are also used in the domestic laws of contracting states, since this may give rise to conflicts of qualification. This also poses problems for courts on how to interpret and apply treaties properly and consistently.

The second sub-problem asks whether the revised interpretation of Article 23 adequately addresses the issue of conflict of qualification and secondly, whether it provides any relief to the problem. If not, should this question be resolved on the basis of an interpretation of the “renvoi clause” (i.e. Article 3(2))?  

As a result of the technical complexity of international taxation, divergent interpretation and application of tax treaties by two given countries may often cause double taxation or double non-taxation. The sub-problem is: Do double tax agreements modelled on the OECD MTC provide sufficient relief for potential double taxation or double non-taxation caused by conflict of qualification.

The next sub-problem arises from conflicts of income allocation between two contracting states. This entails situations in which the two contacting parties classify the income differently for domestic tax law and treaty purposes. For instance, what happens when a permanent establishment is considered to exist by the residence state only? A conflict can arise if the residence state considers that there is a permanent establishment in the other state but the other state does not. It is also important to determine whether domestic tax law would classify all income of a permanent establishment as business profits. It is therefore necessary to separate the question whether there are business profits from the question whether there is a permanent establishment.

Partnership structures use in an international context poses considerable taxing problems, due to the partnership’s heterogeneous treatment by different countries for domestic tax law purposes. The same partnership may be treated as taxable entity in one country, but as fiscally transparent in the other country. These two basic tax concepts may clash together resulting in a conflict of qualification between the countries involved. Same conflict can be brought by use of hybrid entity, as their tax treatment usually varies from one country to another.

1.7. **Chapter outline**

The remaining chapters will be arranged as follows:

1.7.1. *Chapter 2 – Interpretation of tax treaties*
Chapter 2 will examine Article 3 of the OECD MTC. This article sets out the general definitions and principles which are to be used when interpreting a treaty. This chapter will focus on the states’ constitutional rules, states’ tax law interpretation principles applicable to tax statutes and whether tax treaties should be interpreted according to the internationally accepted interpretation principles which are used for international agreements generally and for tax treaties specifically.

With an attempt to fully comprehend the concept of ‘conflict of qualification’, chapter 2 will highlight the importance of sound interpretation principles of international agreements such as tax treaties by discussing, inter alia, the following:

- Article 31 of the Vienna Convention on the Law of Treaties;
- Article 3(2) (also known as the ‘renvoi clause’) of the OECD MTC;
- The various international cases in which the courts have discussed the interpretation of tax treaties; and
- Views of leading international tax authors, such as Professors Klaus Vogel and Michael Lang.

This chapter will thus focus on the issue of which contracting state should apply the tax treaty and its domestic law interpretation in the situation where there are qualification conflicts.

1.7.2. Chapter 3: Articles 23 and 25 of the OECD MTC

This chapter examines the extent to which Articles 23 and 25 resolve the qualification conflict. This chapter considers:

- The effectiveness of Article 23 in addressing conflicts of qualification. The focus is on paragraphs 32.1 – 32.7 of the Commentary to Article 23;
- The phrase “in accordance with the provisions of this Convention, may be taxed in the other Contracting State” as contained in the Article; and
- The effectiveness of Article 25 in addressing conflicts of qualification.

1.7.3. Chapter 4: Double taxation

This chapter examines how conflicts of qualification lead to juridical double taxation i.e. instances where income or capital is taxed in the hands of the same taxpayer more than once, whether by a way of different taxes or, in an international context, by different taxing authorities.

1.7.4. Chapter 5: Double non-taxation

This chapter examines how conflicts of qualification can lead to double non-taxation in both source and resident states. It will also examine paragraph 4 of Article 23A (i.e. Article 23A(4)), whose purpose is to avoid double non-taxation as a result of disagreements between contracting states.
1.7.5. Chapter 6: International income attribution conflicts

This chapter assesses the cross-border income attribution conflict, and will, *inter alia*, address:

- The attribution of income for both domestic tax law and tax treaty purposes; and
- Practical examples to highlight both complications of and potential solutions to qualification conflicts.

1.7.6. Chapter 7: Taxation of cross-border partnerships and hybrid entities

This chapter focus on the impact on of conflicts of qualification on taxation of cross-border partnerships, its partners and hybrid entities. It will deal with the following:

- The application of OECD Model Tax Convention and its Commentary to the taxation of cross-border partnerships.
- It highlights different features of partnerships and their different qualification for tax purposes.

1.7.7. Chapter 8: International case law

This chapter will summarise the existing case law, discussing how the courts have attempted to resolve the conflicts of qualification. Some examples of the qualification problems addressed in case law may help to define this difficult concept.

1.7.8. Chapter 9: Conclusion

This chapter will summarise the findings of the research, draw conclusions and propose areas requiring further research.
2. INTERPRETATION OF TAX TREATIES

2.1. Background

Words are imperfect symbols to communicate intent. Moreover, words are ambiguous and often their meanings change over time. It is also accepted that the English language is not an instrument of mathematical precision. Therefore, no document such as a treaty can expressly resolve all issues that may arise in the course of its application. Thus, like any other legal text, tax treaties require interpretation and leave room for disagreement. Treaties like other legal documents must be interpreted keeping in mind the intentions of the parties involved. These intentions cannot be completely circumscribed in words (Gulati 2013).

Also, it is not within human powers to foresee the manifold set of possible circumstances which may arise in the future, and even if it were so, it is not possible to provide for all of them with absolute precision. No written document can thus cater for all possible circumstances. All these aspects add to give prominence to the problem of interpretation and application; and thus to the practical application of treaties (Gulati 2013).

International agreements, like all legal texts, require interpretation. The need for interpretation can arise from a difference of opinion between contracting states; the agreement will then be interpreted by these states, or, if they have subjected themselves to its jurisdiction in general or for a particular case, by the International Court of Justice. Questions of interpretation with regard to application of a treaty can also arise, however, before domestic administrative authorities or courts (Vogel, 1996).

The approach towards interpretation (of tax treaties) varies across the world. However, Gulati (2013) suggests there are three main approaches which are practised around the world:

1. **Objective approach**

   - Under this approach, the intention of the parties must be determined from the words of the document taken as a whole and to achieve the ‘ordinary’ meanings of words are assigned to the words of the document. This is the so-called Golden Rule of interpretation. This is also regarded as the literal or legalistic method of interpretation and gives the adjudicator limited discretion. For this reason it can be referred to as the objective or literal approach. However, this is prone to several problems including of translation and other cultural differences.

2. **Subjective approach**

   - Under this approach, the intentions of the parties are determined drawing upon a broader range of material other than the literal meanings of the words of the treaty. However, interpreting the intentions is itself more subjective.

3. **Teleological approach**

   - Under this approach, the aims and objectives of the treaty are considered allowing scope for a much broader interpretation of the treaty. The treaty is interpreted so as to achieve the
purpose of the treaty and can adapt to changing circumstances. The rules of interpretation are thus more liberal.

In practice, most countries will construe a tax treaty liberally, that is tend towards the Teleological approach. Where an interpretation based on the narrow literal meaning of certain words would give a result which is at odds with the intention of the treaty which broadly speaking is to relieve double taxation the broader Teleological approach seeks rather to achieve the broad objective. Therefore, in such cases a broader interpretation will usually be allowed. This is consistent with Article 31 of the Vienna Convention (discussed below) which provides that treaties must be interpreted by the parties 'in good faith', so that a broad interpretation is to be favoured over a narrower literal interpretation (Gulati 2013).

The extent to which statutory text or statutory purpose should control the interpretation of an international agreement was actively disputed in the older literature on international law. Difference of opinion also existed regarding the meaning of protocols of negotiation and other materials. The most widely-held view was that treaty obligations are to be interpreted restrictively, because parties to a treaty in doubtful cases should only be presumed to have waived their sovereignty to the extent that is unequivocally apparent from the text of the treaty (Vogel 1996).

In case of Gladden Estate vs. the Queen (1985) DTC 5188, the Canadian Federal Court said:

"Contrary to an ordinary taxing statute a tax treaty must be given a liberal interpretation with a view of implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned."

2.2. Vienna Convention on the Law of Treaties

Tax treaties are examples of international agreements and thus subject of international law treaties. Their creation and consequences are determined according to the rules contained in the Vienna Convention on the Law of Treaties of 23 May 1969 (hereinafter referred to as "VCLT") (Vogel 1996).

The international law of treaty interpretation is codified in Articles 31 – 33 of the VCLT. Article 31(1) states the "general rule of interpretation" that a treaty "shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

Article 31(1) contains three separate principles namely:

1. Paramount principle
   - This is a radical idea that a treaty must always be interpreted in good faith.

2. Secondary principle
   - It states that the words used in a treaty should be given their ordinary meaning.
This principle is based on the view that the ordinary meaning of the words of the treaty must be presumed to be the authentic expression of the intention of the parties. This presumption is rebuttable.

3. Tertiary principle

- It states that the ordinary meaning to be given to the words of the treaty be determined, not in isolation, but -
  - in the context of the treaty; and
  - in the light of its object and purpose.

Article 31(2) of the VCLT elaborates on this general rule providing that the context of a treaty comprises, in addition to its text, any related agreement or instrument accepted by the parties as related to the treaty. Article 31(3) requires to be “taken into account, together with the context” subsequent agreements between the parties, subsequent practice establishing the parties’ agreement regarding its interpretation, and any relevant rules of international law applicable in the relations between the parties. Article 31(4) allows for special meanings to be given to treaty terms where the parties so intend.

Article 32 states that the interpreter of a treaty may have recourse to “supplementary means of interpretation”, including the preparatory work of the treaty (the travaux préparatoires) and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31 or to determine the meaning where the interpretation according to Article 31 is ambiguous or obscure, or leads to a manifestly absurd or unreasonable result (Gulati 2013).

It should be noted that there is no direct reference to Commentaries in the VCLT. This leaves the debate open whether or not these fall within Article 32 only as supplementary material, and thus has less influence than if they were included under Article 31, the general principles. However, their widespread acceptance by the Courts renders this debate to be academic. The Commentaries are now updated from time to time separately from the MTC Convention itself (Gulati 2013) and have an influence as to how the MTC is interpreted.

In interpreting international agreements according to these rules (of VCLT) the text of the treaty is of primary importance; i.e. the ‘ordinary meaning’ of the terms and the wording not of the individual provision, but that of the entire agreement taken in context. The (older) view that primarily what is looked for is the subjective intent of the parties to the treaty has given way to the broader form of interpretation. However, subjective elements are not entirely excluded from considerations as they are implied within the purpose of the treaty. The ‘purpose’ referred to by VCLT, certainly, is not synonymous with the subjective intention of the contracting states, but refers to the goal of the treaty as reflected objectively by the treaty as a whole taken in a broader context. Moreover, such purpose is subordinated to the wording of the treaty by the application of rule contained in Article 31 that the purpose shall influence interpretation merely by giving ‘light’ to the terms of the treaty. In other words, ‘purpose’ is not itself an independent means of interpretation (Vogel 1996).
2.3. **OECD Commentary**

The OECD MTC and its Commentary carry significant weight in the interpretation process of an actual treaty if the contracting states chose to follow the wording of the OECD MTC in drafting a certain provision in the actual treaty. It is then only reasonable to assume that they intended such a provision to have the meaning it has in the OECD MTC and as elaborated upon in the Commentary. This does not necessarily apply, however, if the wording of a provision deviates from the OECD MTC. In such an event, two alternatives have to be considered: The difference in wording may also entail a difference in meaning – or the meaning of the provision may be similar to the OECD MTC, despite the difference in wording. This problem cannot be solved in general but only through interpretation in each individual case. If the wording of a provision deviates from the OECD MTC, it is a matter of interpretation to determine whether the difference in wording also results in a different meaning. Consequently, a difference in wording alone is insufficient to rule out the relevance of the OECD MTC and the OECD Commentary. It is, however, also necessary to give reasons why the OECD Commentary should be considered under such circumstances (Lang et al. 2008).

The OECD MTC and its Commentary are very important for the interpretation of tax treaties in that they provide a source from which the courts of different states can seek a common interpretation (Vogel 1996).

Article 3 of the OECD MTC sets out the general definitions and principles which are to be used when interpreting a treaty. Article 3(2) contains a special rule of treaty interpretation. This is because a treaty cannot define each and every term used therein, and therefore it is important to specify a rule which may be used in case of terms undefined in a treaty. It states:

“As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.”

There is a tension between using the domestic law meaning of a treaty term in accordance with article 3(2) (which has the result that a treaty relieving provision has the same scope as a country’s taxing provision, so that if a treaty prevents the source state from taxing pensions, it cannot tax whatever it considers to be a pension under its law), and using a common meaning (which has the result that the treaty relief has the same scope in both countries) (Gulati 2013).

Article 3(2) is drafted in mandatory language as it states that any undefined term “shall” have the meaning that it has under the domestic law of the state applying the treaty, unless the context otherwise requires. Thus, *prima facie*, the domestic legal meaning of the treaty term must always be used. The only specific exception to this rule is that the context may require the application of different meaning. Whether and when the context may so require, in principle is a matter of debate.
The caveat “unless the context requires otherwise” is one of the recurring questions in the debate surrounding article 3(2). Whether and when the context requires otherwise, however, is a precarious matter i.e. not every apparently convincing interpretation from the context should give rise to a divergence from the rule of Article 3(2), but only those based on strong arguments. Thus, whether the context suggests an alternative interpretation that is sufficiently persuasive to overthrow the domestic meaning of the treaty term at issue, is a matter that can be decided based on the facts of each case (Gulati 2013).

The context in which a term is defined is to be determined by the intention of the contracting countries when signing the Convention, as well as the meaning given to the term in the legislation of the other country. The Commentary does not help when it comes to deciding what alternative meaning to that used in domestic tax law ought to be used, given that the context requires a different meaning. There is no general answer to this question: it is a matter of negotiation between the two countries.

Rule of interpretation set out in Article 3(2) reflects a special relationship between a tax treaty and domestic laws of contracting countries. It shows a desire to preserve the tax sovereignty of the contracting country and acknowledges that a treaty does not exist in a legal vacuum, but necessarily operates on the basis of tax laws of the contracting countries to which it applies (Gulati 2013).

When a treaty term is not defined in the treaty itself, or when it is inadequately defined, an issue of qualification often arises. Qualification (conflict) refers to a situation in which the contracting countries impute different interpretations to the term under their respective domestic laws (van Raad 2001).

The Australian Tax Office (ATO TR 2001/13), for instance, takes a position that -

“the commentaries…provide guidance on interpretation and application of the tax conventions and as a matter of practice will often need to be considered in interpretation of DTAs, at least where the wording is ambiguous which…is inherently more likely in treaties than in general domestic legislation.

Unless it is apparent that the substance of the OECD Model has itself changed since a DTA was negotiated or the treaty in question does not conform to the OECD Model, or unless the Commentaries make clear that a former interpretation has actually been substantively altered, rather than merely elaborated, the ATO considers it appropriate, as a matter of practice, to consider, at least, the most recently adopted/published OECD Commentaries…as well as others which may have been available at the time of negotiation”.

2.4. Judicial precedents in the interpretation of treaties

Interpretation of tax treaties was summed up in the case of IRC vs. Commerz Bank AG [1990] STC 285 (UK), which states that a judge ought to:

- Use a purposive approach;

- Bear in mind that the language of a treaty differs from the legal language found in domestic law and not necessarily use domestic legal precedent or technical rules;
• Bear in mind the 'good faith' principle;

• Where appropriate, use supplementary means and travaux préparatoires (preparatory work); and

• Bear in mind the reputation of foreign courts when relying on their judgments.

Illustrative list of case laws supporting the use of commentaries for interpretation of treaties:

• Sun Life Assurance of Canada vs. Pearson [1984] STC 461 (UK)

• Crown Forest Industries Ltd. vs. the Queen [1992] 95 DTC (Canada Federal Court)

• Cudd Pressure Control Inc. vs. the Queen [1999] CTC (Canada)

• Thiel vs. FCT [1990] ATC 4717 (Australia)

Other judicial precedents in the interpretation of treaties include:

• “If the literal rules result in ambiguity or absurdity, the court should try to interpret in another manner” (River wear Commissioners vs. Adamson (1876-77) L.R. 2 App. Cas. 743, HL)

• “Office of the judge is not to legislate, but to express the intention of the legislature” (Stock v Frank Jones (Tipton) Ltd [1978] 1 WLR 231 HL)

• “Rules of interpretation in respect of international treaties are different to those applicable in respect of domestic laws” (Azadi Bachao Andolan 2003 263 ITR 706 Supreme Court of India)

• “The language of an international convention has not been chosen by an English parliamentary draftsman. It is neither couched in the conventional English legislative idiom nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted … unconstrained by technical rules of English law, or by English legal precedent, but on broad principles of general acceptation” (Fothergill v Monarch Airlines Ltd. [1981] AC 251 (UK))

• This is also recognized by the High Court of Australia in Thiel, which held that “the Model Convention and Commentaries […] are documents which form the basis for the conclusion of bilateral double taxation agreements of the kind in question and […] provide a guide to the current usage of terms by the parties. They are, therefore, a supplementary means of interpretation to which recourse may be had under Article 32 of the Vienna Convention”

• In McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation (2005) 142 FCR 134 at 144, the court takes the following position on this issue: “Certainly the commentary has been used to assist in the interpretation of double tax agreements based upon it, although there may be a theoretical difficulty in using commentary published after the adoption of a double
taxation agreement as relevant to the construction of that agreement...whether there may be a different result in taking into account commentary published after ratification of an agreement is not a matter that need concern us here”.

2.5. Conclusion

The OECD MTC and its Commentary could qualify as “supplementary means of interpretation” under Article 32 of VCLT. The preparatory work of the treaty and the circumstances of its conclusion are expressly referred to in Article 32 of VCLT as examples of such material. The use of supplementary means of interpretation is not limited to material expressly mentioned in Article 32 of VCLT. Recourse may be had to any evidence establishing the common intention of the parties. If tax treaty negotiations are based on the OECD MTC and its Commentary may provide guidance in establishing the meaning of treaty provisions. Consequently, the OECD MTC and its Commentary qualify as supplementary means of interpretation under Article 32 VCLT, provided that the treaty provision in question is based on the OECD MTC (Lang et al. 2008).

There are two separate issues that arise from the discussions above, and they are as follows:

- Since article 3(2) requires recourse to internal law as it is from time to time, there is a limit to changes to internal law, beyond which the change has no effect on interpretation.

- A change in the law that does have effect in interpreting the treaty may breach the treaty; the remedy for a material breach is termination of all or part of the treaty (which may do more harm than good).

On the limit of changes within article 3(2), the Commentary draws the line between preventing a state from changing its internal law to make the treaty partially inoperative and preventing the need to refer to earlier law, but is not very clear about how one determines the limit.

Override is not possible in all countries because treaties may have a higher status than internal law. Some changes in the law that override the treaty are in order, for example, restoring the position to what both parties thought it was before a court decision to the contrary. The OECD report on treaty override disapproves of override even when designed to prevent improper use of the treaty. It encourages consultation to solve treaty problems and states that override will be publicly and forcefully condemned.

The OECD Model Convention and the OECD Commentary carry significant weight in the interpretation of double taxation conventions. If a double taxation convention is, in principle, based on the OECD Model and a certain provision follows the wording of the OECD Model, it is then only reasonable to assume that the contracting states intended such a provision to have the meaning it has in the OECD Model, as outlined in the OECD Commentary. Amendments to the OECD Model Convention and to the OECD Commentary made after the conclusion of a double taxation convention have to be seen in a different light. Later Commentary amendments cannot serve to establish the
parties’ intentions upon conclusion of a double taxation convention. Such amendments may only play a limited role in the interpretation of previously concluded double taxation conventions if recourse to other means of interpretation remains inconclusive (Lang et al, 2008).

In the cases where the treaty and domestic law conflict, the treaty must be interpreted in a way that would not frustrate its object and purpose. The Commentary supports this view (refer to paragraph 9.5. of the Commentary in respect of Article 1 of OCED MTC). In interpreting the treaty to ensure the object and purpose of the relevant provisions are adhered to, the test is different under the treaty to domestic law. This is because the focus is upon “whether a main purpose” for the transaction was to secure a more favourable tax treatment inconsistent with the object and purpose of the treaty provisions. The domestic test has a lower threshold being a “more than merely incidental purpose” of tax avoidance. This difference could be important in situations where the treaty provisions conflict with domestic law (Elliffe et al, 2011).

From a South African perspective, in the February 1995 matter of The State versus T Makwanyane and M Mchunu, the Constitutional Court dealt with the constitutionality of the death penalty. The then newly adopted Constitution (concluded in 1993) did not explicitly address the matter of capital punishment. It was left to the Constitutional Court to decide whether the death penalty is consistent with the provisions of the Constitution, Chapter Three in particular which sets out the fundamental rights to which every person shall be entitled under the Constitution. Chapter Three also sets out provisions by which the chapter is to be interpreted by the Courts. It was argued on behalf of the accused that the imposition of the death penalty for murder was a cruel, inhuman and degrading punishment that should be declared unconstitutional.

Chaskalson P made broad and resourceful use of international law in his delivery of judgment. In paragraphs 12-17 of the judgement, it was argued that documents used during the negotiating process (specifically those relating to the position of the death penalty), formed part of the context within which the Constitution should be interpreted. He considered circumstances existing at the time the Constitution was adopted, in interpreting the relevant provisions of the Constitution. Chaskalson found authority permitting the use of such evidence in international law. He referred to the European Court of Human Rights and the United Nations Committee on Human Rights whose deliberations are informed by travaux preparatoires as described by Article 32 of the VCLT. The learned Judge further referred to other countries where the constitution is the supreme law such as Germany, Canada, the United States and India, where courts may have regard to circumstances prevailing during the drafting of the Constitution. He also makes reference to the VCLT, which may assist the court in interpretation of the Constitution.

In this case, the Constitutional Court adopted a liberal and creative approach to the interpretation of the Bill of Rights. Paragraph 9 of the judgement reads as follows –

“...this Court dealt with the approach to be adopted in the interpretation of the fundamental rights enshrined in Chapter Three of the Constitution. It gave its approval to an approach which, whilst paying due regard to the language that has
been used, is “generous” and “purposive” and gives expression to the underlying values of the Constitution…”

The judgment is of great importance and interest, not only in that it declares capital punishment to be unconstitutional, but also in that it lays down fundamental guide-lines for constitutional interpretation.

Chaskalson concludes that international and foreign authorities are of value because they analyse arguments for and against capital punishment and show how courts of other jurisdictions have dealt with the issue. Such sources may also have to be considered because of their relevance to Section 35 (1) of Chapter Three of the Constitution, which states:

"In interpreting the provisions of this Chapter a court of law shall promote the values which underlie an open and democratic society based on freedom and equality and shall where applicable, have regard to public international law applicable to the protection of the rights entrenched in this Chapter, and may have regard to comparable foreign case law."
3. ARTICLES 23 AND 25 OF THE OECD MODEL TAX CONVENTION

3.1. Background

Article 23 falls within Chapter V of the OECD MTC entitled “Methods for elimination of double taxation”, and it is split between Article 23A (the so-called “Exemption method”) and Article 23B (referred to as “Credit method”).

These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one state. This case has to be distinguished especially from the so-called economic double taxation, where two different persons are taxable in respect of the same income or capital. If two states wish to solve problems of economic double taxation, they must do so in bilateral negotiations (paragraphs 2-3 of the Commentary).

Unusually, Article 23 allows for two alternative methods (Couzin 2001):

- Version A is a modified exemption system. The state of residence agrees to provide –
  - “exemption with progression” in respect of income or capital that, in accordance with the provisions of the convention, may be taxed in the other state; and
  - a foreign tax credit for tax imposed by the source state on dividends and interest.

- Version B is a simple credit model. The State of residence allows a credit in respect of tax paid to the other state on income or capital that, in accordance with the provisions of the convention, may be taxed in the other state, but not exceeding the residence state tax attributable to such income or capital.

As no international tax court exists, problems arising under treaty have to be adjudicated by one of the contracting states. One of the avenues of adjudication is to make use of the mutual agreement procedure. Under the general definitions (Article 3) in the OECD MTC, it is provided that a state will indicate in the treaty who will act as the competent authority. In a South African context, the competent authority is the Commissioner for the South African Revenue Service or his duly authorised representative (Honiball & Olivier 2011).

The provisions of Article 25 deals with the mutual agreement procedure to resolve conflicts, such as qualification conflicts between contracting states, brought about differing interpretations of treaty terms or of domestic law in relation to the provisions of double tax treaty. Conflicts of qualification may result in different imposition or non-imposition of tax by either the resident or source state or both.

3.2. Article 23 and qualification conflicts

Here is an overview of both Articles 23A (exemption method) and 23B (credit method) as provided by Professors Honiball and Olivier (2011):
Paragraphs 32.1 through 32.7 of the Commentary contain guidance on how relief from double taxation is to be provided under the OECD Model in cases of conflicts of qualification.

Paragraphs 32.1 – 32.2 of the Commentary states the following:

“Both Articles 23A and 23B require that relief be granted, through the exemption or credit method, as the case may be, where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention. Thus, the State of residence has the obligation to apply the exemption or credit method in relation to an item of income or capital where the Convention authorises taxation of that item by the State of source.

The interpretation of the phrase “in accordance with the provisions of this Convention, may be taxed”, which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.”

In cases of conflict of qualification, the Commentary, not the Model itself (meaning not any specific Article of the MTC), considers that where the source state interprets the treaty so as to preclude its right to tax under the treaty, the state of residence may consider that the item of income may not be taxed by the state of source in accordance with the provisions of the convention and, thus, does not become required by Article 23A(1) to exempt the item of income under the requirements of the treaty.

In that case, the Commentary considers that the residence state is not bound by the treaty classification of the income made by the source state, but by the result of such a classification made by the source state preventing it to exercise its tax jurisdiction (Prats 2011).

However, the involved countries could classify the income inconsistently for the purposes of tax treaty provisions. If so, it becomes relevant to interpret the sentence “in accordance with the provisions of this Convention, may be taxed”. If inconsistencies arise from the application of the provisions of the tax treaty, due to the differences included in the domestic laws of the contracting states, the income is still being taxed in accordance with the provisions of the Convention, as it is interpreted and applied
by the source state. As a result, the residence country, despite of the existing conflict of qualification must grant the corresponding double tax relief measure.

In the context of conflicts of qualification between the state of source and the state of residence, for purposes of elimination of double taxation, paragraph 32.3 of the Commentary provides that:

“where due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from double taxation be granted by the State of residence, notwithstanding the conflict of qualification resulting from these differences in domestic law.”

According to paragraph 32.3, a qualification conflict arises if the source and residence states apply different treaty provisions as a result of the reference to domestic law in Article 3(2) of the OECD MTC, for the interpretation of terms not defined in a tax treaty (Potgens et al. 2012).

Since 2000, and as a result of the OECD Partnership Report implemented in the Commentary, the qualification conflicts have been resolved by requiring the residence state to follow the source state’s qualification. This position is based on the wording of Article 23 (23A and 23B read together). The residence state must provide double taxation relief (credit or exemption) for an income component that “in accordance with the provisions of this convention, may be taxed in the other contracting State” (Potgens at al. 2012). This means if the conflict only arises as a consequence of applying the different domestic laws, but the source country applies the treaty correctly to that income, the country of residence should then grant the relief as the source country levied the tax in accordance with the treaty (de Goede 2013). Therefore, the resident state, when applying Article 23, does not categorise the income itself or check whether it would have been allowed to tax the income if it were the source state. It examines whether the source state has taxed the income in accordance with its domestic law and the relevant double tax agreement.

Paragraph 32.5 of the Commentary states the following –

“Article 23 A and Article 23 B, however, do not require that the State of residence eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable...conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification...where the divergence is based not on different interpretations of the provisions of the Convention but on different provisions of domestic law...States should use the provisions of Article 25 (Mutual Agreement Procedure), and in particular paragraph 3 thereof, in order to resolve this type of conflict in cases that would otherwise result in unrelieved double taxation.”

The solution for qualification conflicts proposed in the Commentary (and as discussed above) has its origin in the International Tax Group (Jones et al. 1996). An important difference with the International
Tax Group’s interpretation is the restrictive definition of the qualification conflicts applied in the Commentary. This means that if the two states does not apply Article 3(2) of the OECD MTC because, for example, its domestic law has failed to define a term that requires interpretation or if the meaning attributed to it in domestic law is applied in a different context than that in the applicable tax treaty, or if it has no specific legal meaning, then this would involve a conflict of interpretation within the meaning of paragraph 32.5 of the Commentary. Such an interpretation conflict must be resolved by means of the mutual agreement procedure of Article 25 of the OECD MTC. Paragraph 32.5 of the Commentary describes interpretation conflicts as differences that arise due to different interpretations of tax treaty provisions or different interpretations of the facts being followed (Potgens at al. 2012).

Solutions put forward elsewhere in the Commentary indicate that the OECD is aware that its definition of qualification conflicts is rather restrictive. An example of this is paragraph 48 of the Commentary to Article 7 (i.e. Business profits taxation article) that was included in 2008: If both contracting states apply different methods for the allocation of free capital to a permanent establishment (both methods being in accordance with the authorized OECD approach), the method applied by the state in which the permanent establishment is situated must be followed (Potgens at al. 2012).

Finally, the OECD (in paragraphs 56.1 – 56.3 of the Commentary) considers that inconsistencies resulting from characterizations granted by the involved states might lead to loopholes benefiting from double non-taxation. In order to counteract potential tax planning targeted to this end, the OECD suggests that in case the state of source and the state of residence adopt different interpretations of the facts or of the provisions of the Convention, the state of residence is not obliged to grant the exemption relief, when the source state has exempted or reduced its taxation and the residence country interprets that the tax must be actually paid at source. In addition, when due to the differences in domestic laws, the source state applies a provision inconsistent with the double tax treaty article that residence would have applied, the latter is not required to exempt this income (see paragraphs 32.6 and 32.7 of the Commentary).

### 3.3. Article 25 (Mutual Agreement Procedures)

To resolve qualification conflicts, Article 25 of the OECD MTC provides for a 'mutual agreement procedure'. This procedure consists of negotiation between the ‘competent authorities’ of the contracting states with the view to secure the uniform application of the tax convention in both countries (Groen 2002).

Where a conflict of qualification arises due to differences in the domestic law between the state of source and the state of residence and in consequence the former applies to a particular item of income provisions of the convention that are different from those that the state of residence would have applied to the same item, the income is still taxed in accordance with the provisions of the convention, as interpreted and applied by the state of source. In such a case, the tax credit method could be applied but the solution to be implemented in general requires that the competent authorities of the two states consult each other through the mutual agreement procedure in order to clarify
whether the conflict results from the differences in the domestic laws or from the interpretation of the relevant provisions of the convention or from a differing interpretation of the factual situation (Lousa 2011).

When the qualification conflicts arise between the contracting states due to the differing interpretation of the facts or the different interpretation of the provisions of the treaty, the OECD Commentary on Article 23 do not impose the obligation to grant the credit or the exemption relief, in relation to the taxation applied by the source state. Examples about the three potential conflicts of qualifications (domestic laws, interpretation of facts and provision of the treaty) are included in the Commentaries on Article 23, paragraph 32.4 (domestic laws) and 32.5 (interpretation of facts and provisions of the Convention). In those cases, the solution must be obtained through the Mutual Agreement Procedure or by accepting as a final result an unrelieved double taxation.

Here is an overview of Article 25 as provided by Professors Honiball and Olivier (2011):

<table>
<thead>
<tr>
<th>Article 25</th>
<th>Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Para 1</td>
<td>Taxpayers have the right to appeal (within 3 years) to the tax authorities in the state of Residence in circumstances where taxation is not in accordance with a treaty.</td>
</tr>
<tr>
<td>Para 2</td>
<td>Where the objection appears to be justified, the competent authority must endeavour to solve the dispute. Agreements reached by the competent authorities will be implemented notwithstanding any time limits under the domestic law.</td>
</tr>
<tr>
<td>Para 3</td>
<td>Competent authorities may consult one another to solve the problems of treaty interpretation and application, as well as to resolve any problems of double taxation, whether or not dealt within the treaty.</td>
</tr>
<tr>
<td>Para 4</td>
<td>Consultation between competent authorities may take any form, including joint meetings between them or their representatives.</td>
</tr>
<tr>
<td>Para 5</td>
<td>Provision is made for a mandatory arbitration of issues unresolved within 2 years at the request of the taxpayer.</td>
</tr>
</tbody>
</table>

To resolve these conflicts (of qualification), Article 25 provides for a ‘mutual agreement procedure’. This procedure consists of negotiations between the ‘competent authorities’ of the contracting states with a view to secure the uniform application of the tax convention in both countries (Zuger 2002).

Article 25(1) and 25(2) provide that the competent authorities of the two contracting states must endeavour to resolve disputes leading to inconsistent taxation under the convention (Rohatgi 2002). It is specifically provided that the mutual agreement procedure exists irrespective of any domestic remedies (see Article 25(1)). The result is that a taxpayer who makes use of the mutual agreement procedure may still want to or need to object and appeal against an assessment in terms of domestic law. Unlike under domestic legislation where a taxpayer has to wait for a formal assessment to make use of the objection procedure, the mutual agreement procedure may be initiated by a taxpayer once he or she is certain that a contracting state will apply the treaty in a specific manner without a formal assessment having been received (see paragraph 12 of the Commentary on Article 25). A taxpayer
has three years from the date of the first notification of an action resulting in a liability to make use of the procedure (see Article 25(1)).

According to Article 25(3) of the OECD MTC, the competent authorities will try to settle “any difficulties or doubts arising as to the interpretation or application of the convention”. The competent authorities will procedure shall solve conflicts between the contracting states (Zuger 2002).

Paragraphs 50 and 51 of the OECD Commentary to Article 25(3) states the following:

“The first sentence of this paragraph invites and authorises the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. These are essentially difficulties of a general nature which concern, or which may concern, a category of taxpayers, even if they have arisen in connection with an individual case normally coming under the procedure defined in paragraphs 1 and 2.

This provision makes it possible to resolve difficulties arising from the application of the Convention. Such difficulties are not only those of a practical nature, which might arise in connection with the setting up and operation of procedures for the relief from tax deducted from dividends, interest and royalties in the Contracting State in which they arise, but also those which could impair or impede the normal operation of the clauses of the Convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the Convention.”

Paragraph 3 of Article 25 may be used to agree on the definition of a specific term used in the treaty, or on procedures to give effect to a specific treaty provision. The resolution reached through the mutual agreement procedure (MAP) will thus potentially concern a number of taxpayers, rather than solely a specific taxpayer or the parties to a specific transaction (as in a case under paragraph 1 of Article 25) (Paragraph 38 of the UN Guide to MAP).

Some countries have found that the use of the authority provided by Article 25(3) helps the implementation of the provisions of the treaty. In addition, where mutual agreements reached under Article 25(3) apply to all taxpayers or a general category of taxpayers, the publication of such agreements, which are not specific to particular cases and therefore do not mention any taxpayer specific information, may serve to provide guidance and prevent potential future disputes (Paragraph 40 of the UN Guide to MAP).

The treaty places neither an obligation, nor a time limit within which the dispute has to be solved, on the competent authorities. An agreement reached under the mutual agreement procedure will be binding despite any time limits set under domestic legislation (see Article 25(2)). It is clear that the mutual agreement procedure involves two stages, i.e. firstly at taxpayer-competent authority level and secondly, at competent authority-competent authority level (Honiball & Olivier 2011).

3.4. Conclusion

When Articles 23A and 23B are interpreted in accordance with the general rule of interpretation embodied in Article 31 of VCLT, that is to say in good faith in accordance with the ordinary meaning to be given to the words “in accordance with the provisions of this convention, may be taxed” in their
context and in the light of the object and purpose of the Convention, the state of residence must conform to the characterisation of an item of income for the purpose of the relevant provisions (Engelen 2004).

The approach taken by the OECD update in 2000 has received mixed reactions. It has been argued that this approach lacks a legal basis under Article 23(1) of the OECD Model, and that it might be regarded by source states as an invitation to extend the taxation rights they have under the treaty, simply by changing either the domestic law as such or merely just its interpretation. Residence states, however, that are not willing to give up their taxation rights may always argue that they do not have to follow the source state’s position if they intend to maintain their taxation rights as a result of an autonomous interpretation of the treaty. They can consider themselves to be required by the “context” of the treaty to do so. As a result, the number of cases of double taxation might even increase. Despite these objections, the OECD Committee on Fiscal Affairs has not reconsidered its approach but, in its 2008 Update, has even extended the scope of that approach in order to be able to prevent double non-taxation in certain other situations. The authority for that approach is weak, since the OECD Update has not broadened its interpretation of Article 23A(1) of the OECD Model in general, but only for situations where it is in the interest of the tax authorities to generate additional tax revenues (Lang 2009).

It cannot yet be confirmed whether the opinion of the OECD on Article 23(1) of the OECD model convention has gained acceptance in practice. There have been doubts that the wording of the provision expresses the meaning intended by the OECD since the year 2000. It is often contested that the phrase “taxed...in accordance with the provisions of the Convention” actually contains a reference to the domestic practice of the source state. In any event, this language does not necessarily seem to imply the understanding intended by the OECD since 2000 (Lang 2004).

Furthermore, the phrase “taxed...in accordance with the provisions of the Convention” could also be understood as meaning that it is up to the tax authorities of the state of residence to judge either independently from the treaty or as an applying state in accordance with Article 3(2) of the OECD MTC based on the understanding familiar to its domestic tax law, whether the source state has the taxation right in a specific situation. Against this backdrop, it is not surprising that some states support the view that the opinion expressed since 2000 in the OECD commentary is not covered by the wording of the model convention (Lang 2004).

Other opinions, however, regard the new commentary on Article 23 of the OECD model convention as relevant for the interpretation of Article 23(1) of the OECD model convention. These views are based on the assumption that the meaning supported by the OECD commentary since 2000 is covered by the wording, or that the intention of the authors of the OECD commentary is explicit enough to replace the clear wording of the convention (Lang 2004).

If one decides, however, to share the view expressed in the commentary on the OECD MTC, either only for future tax treaties or for all tax treaties based on the OECD model convention, another
problem appears. The OECD commentary assumes that the state of residence should be bound by the qualification of the source state only if the qualification results from the domestic tax law of the source state. Some scholars have pointed out that they see no reason for this distinction in the wording of Article 23(1) of the OECD model convention. Therefore, there is a risk that, contrary to the intention of the OECD Fiscal Committee, Article 23(1) of the OECD model convention will result in a commitment to the qualification of the source state, even if this commitment does not result from the originally domestic legislation but from a different interpretation of the convention provisions, or a different interpretation of the facts (Lang 2004).

All these considerations show that there is no certainty over how Article 23(1) of the OECD model convention is actually suitable to prevent double non-taxation in cases of qualification conflicts. The opinions supported by the various states are completely different. We are far from having a consolidated view on the matter. Due to the diverging opinions in academic literature, one can assume that the courts will continue to issue different decisions.

The question also arises as to the binding effect of decisions reached under the mutual agreement procedure. Article 25(2) stresses that any agreement reached by the competent authorities shall be implemented and the OECD Commentary on Article 25 makes it clear that a mutual agreement is binding on the tax authorities (see paragraph 35). However, in IRC v Commerzbank AG and IRC v Bancodo Brazil SA it was held that a mutual agreement procedure had no authority in the English courts as the decisions of a competent authority merely express the views of the tax authorities of the two contracting states and can be either right or wrong (Honiball & Olivier 2011).

The binding authority of the mutual agreement procedure on tax authorities can be understood in light of the fact that as treaty is an agreement between the two contracting states (including the mutual agreement procedure), the states have agreed in advance to be bound by the outcome of the procedure. However, the same does not hold true for the taxpayer. The result is that a resident or national who is aggrieved by the decision, can still approach domestic courts to settle the issue. In such circumstances the court will not be bound by the decision reached under mutual agreement procedure (Honiball & Olivier 2011).
4. DOUBLE TAXATION

4.1. Background

According to OECD (n.d.), the term double taxation arises when comparable taxes are imposed in two or more states on the same taxpayer in respect of the same taxable income or capital, e.g. where income is taxable in the source state and in the resident state of the recipient of such income.

Two different types of double taxation, however, can be distinguished:

- **Juridical double taxation** generally refers to the situation where the same taxpayer is subject to comparable tax on the same income for identical periods in two or more states.

- **Economic double taxation** is a situation where an item of income or capital is taxed in two or more states in the same tax period, but that income or capital is in the hands of different taxpayers.

A fundamental difference between juridical and economical double taxation is consequently that the latter type refers to situations where the income is taxed in the hands of different persons. An important example is the taxation of income generated through a company or a similar business vehicle regarded as taxable person. If the taxation follows the classical system, which represents a straightforward form of economic double taxation, the income will be taxed first in the hands of the entity (corporate taxation) and then additionally in the hands of the owner (dividend taxation). Unlike international juridical double taxation, this double taxation is intentional in the sense that it has been deliberately established through the legislation as a method of taxation. Many countries have, however, adopted systems designed to avoid these cases of economic double taxation (Barendfeld, 2005).

Tax treaties are designed to deal with double taxation on income derived from cross-border transactions. If, however, the two Contracting countries do not arrive at the same conclusion with regard to the tax rights under the treaty, juridical double taxation can occur today (Tan 2006).

One reason for double taxation are so-called “qualification conflicts” where the same circumstances are qualified differently in two jurisdictions (Hoor 2010).

4.2. An example of double taxation as a result of qualification conflict

Hybrid instruments are financing instruments that bear both equity and debt characteristics and qualify, in cross-border scenarios, as equity in one jurisdiction and as debt in the other. Accordingly, payments under such instruments should qualify (at the same time) as dividends or interest, respectively. Therefore, hybrid instruments may lead to double taxation (Hoor, 2010).

An example of double taxation as a result of qualification conflict is illustrated as follows (Hoor 2010):
A company resident in State A ("A-Co") grants EUR 15m to its subsidiary in State B ("B-Co") under a financing instrument bearing both equity and debt characteristics. The annual payments under the instrument amount to EUR 750,000. Under the application of the domestic tax laws of both states, State B classifies the financing instrument as equity (and the corresponding payments as dividends) whereas State A classifies the instrument as debt (and the corresponding payments as interest).

While the dividend payments are not tax deductible in State B, the same payments qualify as interest payments and are fully subject to tax in State A, i.e. resulting in economical double taxation.

Should State A and State B have concluded a tax treaty along the lines of the OECD MTC, the qualification conflict could be solved in the frame of a Mutual Agreement Procedure (Article 25 of the OECD MTC).

4.3. Double tax relief

There are two main techniques used to achieve double tax relief: the exemption method and the credit method. According to the exemption method one state (i.e. the residence state), excludes the foreign income from domestic taxation in cases where the source state is given the exclusive taxing rights. A full exemption is often limited in some respect. A common approach is to recognise the exempted income when determining the taxation of the domestic income, in order to apply a higher tax bracket in a progressive tax system (Barendfeld, 2005).

Under the credit method, the residence state includes all income, domestic and foreign, in the tax base. Upon taxation, double taxation is relieved by granting a credit for the tax paid in the source state against the domestic tax. Where the foreign tax rates exceed the domestic ones, double taxation is avoided in full. Where the situation is reversed, double taxation is relieved. A distinction is made
between ordinary and full credit. An ordinary credit, which is common, limits the credit to domestic tax. That is, where the foreign tax exceeds the domestic tax, a credit is only granted up to the domestic level. In contrast to this, where a full credit is allowed, the excess amount of tax is also credited (Barendfeld, 2005).

Apart from the exemption and credit methods, taxpayers may in many countries deduct the foreign tax from the tax base, this relieving the double taxation. Foreign taxes are consequently regarded as a deductible cost when computing the taxable income. This approach can be referred to as the deduction method.

Relief of double taxation in the event of conflict of qualification, like many other treaty benefits, is further complicated by conflicts in the characterization of income, instruments, or entities by countries (Arnold et al. 2003).

An important issue in any system for double taxation relief is the determination of source. As discussed above, under the OECD approach, source is addressed implicitly by requiring the residence state to provide an exemption or credit in respect of income, or tax on that income, which may be taxed in the source state “in accordance with the provisions of this Convention”. This provision would override domestic source rules in this regard.

For example, income that may be taxed in the other state but, under domestic concepts, would not be foreign source, will qualify for exemption or credit. Under the domestic law approach, source may be dealt with expressly, by including a stipulation that income or gains of a resident of a contracting state that may be taxed in the other contracting state in accordance with the convention shall be deemed to arise from sources in that other state. In the absence of such a provision, the domestic law approach may provide little effective relief.

In either case, where source conflicts are resolved by appeal to taxation “in accordance with the provisions of this Convention” how is that decided? Whose law governs whether the taxation is in accordance with the convention, that of the state of source or that of the state of residence? Should this issue be resolved in Article 23, or be left to the mutual agreement procedure? There has not been any clear answers for these questions, at least from the Commentary perspective.

Under Article 23 of the OECD MTC, the residence State is only bound to eliminate double taxation when, according to the treaty, the source State is enabled to impose tax (paragraph 32.1 of the Commentary on Article 23). However, application of Article 23 does not necessarily imply that in order to eliminate double taxation the residence state has to mandatorily follow the income treaty classification given by the source state. As a result, the OECD MTC establishes different patterns to solve the possible conflicts that may arise (Prats, 2011).

These are listed as follows:

- If the conflict of qualification derives from interpretation issues of the treaty, for instance when the residence and the source state consider that a different provision becomes applicable to
the item of income, the conflict of qualification needs to be resolved through the mutual agreement procedure established in article 25 of the Model (in particular, paragraph 32.4).

- If the conflict of qualification derives from differences of domestic tax law of both contracting states but, in any case, both states act in accordance with the treaty, state of residence must nevertheless grant alleviation of double taxation (paragraph 32.3).

- If the conflict of qualification is the result of different appreciation of the facts by both contracting states, the conflict must be solved through the mutual agreement procedure as well (paragraph 32.5).

This is illustrated in the table below as follows:

### Instances of double taxation

<table>
<thead>
<tr>
<th>Due to:</th>
<th>Differences in domestic laws of contracting States</th>
<th>Different interpretation of facts</th>
<th>Different interpretation of DTT provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD Solution:</td>
<td>Residence State must grant relief.</td>
<td>Mutual Agreement Procedure (Art.25.3)</td>
<td>Mutual Agreement Procedure (Art.25.3)</td>
</tr>
</tbody>
</table>

### 4.4. Conclusion

Under either approach, the tax treaty articles do not generally deal with economic double taxation (although the mutual agreement procedure may do so), “concurrent full liability to tax” (residence conflicts), or triangular situations. The treaty provisions on relief of double taxation are unnecessary where the distributive provisions of the convention allocate taxing jurisdiction on an exclusive basis. Thus, these articles serve a residual function of avoiding double taxation where the source and residence states are permitted to (and do) tax the same items of income. Limiting the jurisdiction of the source state will not eliminate double taxation unless the residence state allows an exemption or a foreign tax credit (Couzin, 2001).

The solution adopted by the OECD Commentaries on Article 23 does not solve all potential double tax relief scenarios in cases of qualification conflicts. In particular, when the country of partnership’s organization treats the entity as non-transparent, whereas the country where the partners are resident considers the partnership as a flow-through entity. Under these particular tax circumstances, the state or partnership’s organization is obliged to grant double tax relief as regards source taxation. Thus, the double taxation is relieved at its first level.

Paragraph 34 of the Commentary states that the exemption method is the most practical method for providing relief from international double taxation because it relieves the state of residence from undertaking the investigations of the actual taxation position in the other state. The operation of the exemption method depends on whether the income may be taxed in the state of source. If so, there is
an absolute obligation to exempt, subject to the exceptions contained in Article 23A (2), (3) or (4) (paragraph 34.1 of the Commentary) (Honiball & Olivier 2011).

According to Vogel (1996), the exemption method is the method which is traditionally used in continental Europe to relief double taxation (arising from conflicts of qualification).

Lang (2004) suggest that in order to avoid double taxation (i.e. positive conflict of qualification), it must be recommended that the state of residence accept the source state interpretation or at least abolishes double taxation, to the extent the source state interpretation is the proper application of the treaty. Only if the source state clearly applied the treaty improperly, should the state of residence enter into a different interpretation.
5. DOUBLE NON-TAXATION

5.1. Background

A possible double non-taxation may also be the outcome of the use of cross-border hybrid financial instruments. In such a case, the OECD MTC does neither clearly state what is the position of the Model itself, nor contains specific measures to counteract or prevent the situation to happen. Until recently, tax treaties mainly dealt with the alleviation of international juridical double taxation, and very few remarks and provisions were devoted to tackle the issue of double non-taxation. In the actual version of the OECD MTC, there are only a few general indications on how to deal with this situation by the residence state, despite the fact that also the source state may indeed also apply measures to counteract double non-taxation (Prats, 2011).

Double non-taxation can be split into two categories. The first one is the intentional double non-taxation (Lang 2004). This is when the state has the intention not to tax the income. The reason for this could for example be income from teachers, research and students. The aim of this is to stimulate the exchange of knowledge across borders (Lang 2004). Another example is tax heavens that have the intention to attract foreign investors. It is in other words the intention from the state that the income should not be taxed. The other one is unintentional double non-taxation. It is when the taxpayer, not the state, has the intention to avoid tax (Scapa et al. 2005).

5.2. OECD Approach to double non-taxation

Paragraph 32.6 of the Commentary to Article 23, which deals with double non-taxation arising from conflicts of qualification, reads as follows -

“The phrase “in accordance with the provisions of this Convention, may be taxed” must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.”

Where, for example, the residence state’s domestic law categorizes the income as type that the source state has the exclusive right to tax and the source state’s domestic law categorizes the income as a different type that it does not have the right to tax, there can be double exemption. This is a problem confined to Article 19 (Government service) and Article 20 (Students) (if the student or business apprentice becomes a resident of the state in which he is studying or training) and to a variation to Article 18 (Pensions) contained in the Commentary (Jones 2003).
Another example that could lead to potential double non-taxation as a result of conflicts of qualification is as follows -

An entity resident in State E buys its own shares from shareholders in State P. According to its domestic law, State E (fiscally transparent) characterizes the income as capital gain and thus does not tax it (Article 13.4 of OECD MTC). According to its domestic law, State P (corporate status) characterizes the income as dividend and gives exemption according to the E-P treaty (different from OECD Model).

5.3. Methods to prevent double non-taxation

OECD states that it is possible to avoid double non-taxation in instances of qualification conflicts by interpreting the meaning “may be taxed in the other contracting state”. Both article 23A and 23B contains the meaning. It is said in the Commentary that the phrase “in accordance with the provisions of this Convention, may be taxed” is important when two contracting states classify the same item of income differently (paragraph 32.2 of the Commentary).

Article 23A(1) OECD MTC can solve a conflict of qualification that occurs from the contracting states domestic law. However, according to Lang (2004), there is no certainty over how article 23A(1) is actually suitable to prevent double non-taxation in cases of conflict of qualifications. One problem with Article 23A(1) is that it assumes that the state of residence should be bound by the qualification of the source state only if the qualification results from domestic law in the source state (Lang 2004). Vogel’s (2003) opinion is that this Article does not solve all the problems with conflict of qualification.

According to the Commentary, when the conflict of qualification arises as a result of differences between in the contracting states domestic laws, it could be solved by interpreting article 23A(1). Paragraph 32.2 of the Commentary states that: “The interpretation of the phrase in accordance with the provisions of this Convention, may be taxed, which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.”

When the exemption method (i.e. Article 23A) is used, the resident state is obligated to exempt the income regardless of whether or not the source state actually subjects the income to tax, if another solution is not expressly proved by the double tax convention. When both states in fact do not impose tax under its domestic laws, it would result in double non-taxation (Kleist 2012). The exemption method by itself could in that situation lead to double non-taxation when the source state has taxing rights under the treaty but does not levy any tax under its domestic law and the resident state does not have any taxing rights. The aim of using the exemption method is to ensure neutral competition in the source state (Lang 2004).
5.4. Conclusion

In 2000 the OECD added a new paragraph to the exemption method. Article 23A(4) is a complementary rule to Article 23A(1) and is supposed to cover those cases when two contracting states disagree on facts or in the interpretation of the provisions in a double tax convention. The purpose of this paragraph is to avoid double non-taxation as a result of disagreements between the state of residence and the state of source (OECD 1999). A conflict may arise when the source state interprets the facts of a case in such a way that an item of income falls under a provision that eliminates the source state's right to tax and the resident state adopts a different interpretation in the provision in the double tax treaty and which result in that the resident state has no right to tax the income (paragraph 56.1 of the Commentary). According to Lang (2004), Article 23A(4) was added as an explicit provision aiming to ensure that in certain qualifications conflicts tax will at least be levied once when certain conflicts of qualification cases result in double non-taxation as a consequence of the application of the convention if the state of residence (paragraph 34.1 of the Commentary).

If the double non-taxation is based on the interpretation of domestic law of the source state, Article 23A (4) is not applicable (Lang 2010). OECD expressly states in the Commentary that Article 23A(4) is not applicable when the source state may tax the income according to the double tax convention but does not tax the income according to domestic law (paragraph 56.1 of the Commentary).

Paragraph 35 of the Commentary states that occasionally contracting states may find it reasonable in certain circumstances to negotiate an exception to the absolute obligation on the state of residence to give exemption in cases where neither Article 23A(3) or 23A(4) would apply. According to the Commentary, the need for such an exception would arise in order to avoid double non-taxation, for example if no tax on specified items of income or capital is provided under the domestic laws of the state of source, or tax is not effectively collected owing to special circumstances such as the set off of losses or the statutory time limit having expired. The Commentary states that the contracting states may negotiate any one of the following three methods to avoid such double non-taxation (Honiball & Olivier 2011):

- The relevant income article may itself be amended;
- An exception to the general rule may be made where one of the states adopts the exemption method and the other the credit method in order to achieve reciprocity; or
- Another exception to the general rule may be made where a state wishes to apply the credit method to specific types of income..

International tax planners may take advantage of mismatches between two or more tax systems for the purpose of reducing the total tax liability through double non-taxation of income (for example, income is tax exempt both in the source and resident state) or double deduction of losses (for example, losses are deducted both in the source and resident state). This is a legitimate practice as long as it complies with the domestic tax laws and the respective tax treaties in place (Schneider et al. 2014).
Germany is currently one of the countries spearheading the above-mentioned development. In the preamble of the German-MC, the German tax administration states that its intention is not only to eliminate double taxation, but also to prevent (double) non-taxation. Thus, it can be assumed that its future tax treaty policy will mainly target the following cases of double non-taxation (Schneider et al. 2014):

- The source state applies the tax treaty in any way whereby it feels restricted by the treaty not to tax the income while Germany grants as a residence state tax exemption under the tax treaty.
- The relevant income is tax exempt both in the source and the residence state due to diverging domestic tax laws.

The table below illustrates the OECD solutions in instances of non-double taxation:

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<tbody>
<tr>
<td><strong>OECD Solution:</strong></td>
<td>Residence State must grant exemption notwithstanding the conflict of qualification (para 32.3 of Comments on Article 23.A)</td>
<td>Residence State must <strong>not grant</strong> exemption because source State ‘may not tax in accordance with the provisions of the Convention’ (para 32.7 on Article 23.A)</td>
<td>Article 23A(4): Residence State must <strong>not apply</strong> exemption (para 32.6 on Article 23A)</td>
<td>Article 23A(4): Residence State must <strong>not apply</strong> exemption (para 32.6 on Article 23A)</td>
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**Instances of non-double taxation**
6. TAXATION OF CROSS-BORDER PARTNERSHIPS AND HYBRID ENTITIES

6.1. Background

The use of cross-border partnerships confronts consultants and clients with considerable taxing problems, due to the partnership’s heterogeneous treatment by different countries for civil law and tax law purposes. The same partnership may be treated as taxable entity in one country, but as fiscally transparent in the other country, where tax liability is instead conferred to the partners of the partnership. In a cross-border partnership structure these two basic tax concepts may clash together resulting in a conflict of qualification between the countries involved. As the countries are of a different view of who constitutes the taxpayer, the application of tax treaties gives rise to serious problems and may even result in double taxation not adequately avoided.

A number of other difficulties arise where different rules of the tax treaty are applied by the contracting states to income derived by a partnership or its partners, depending on the domestic laws of these states or their interpretation of the provisions of the tax treaty or of the relevant facts. These difficulties relate to the broader issue of conflicts of qualification, which is dealt with in paragraphs 32.1 ff. and 56.1 ff. of the Commentary (paragraphs 6-7 of the OECD Commentary to Article 1).

Due to these potential tax conflicts, partnerships became a focus of discussion among international academics and subject to countless legal writings, resulting in various approaches and principles in this respect. The tax treatment of partnerships has however never been dealt with as thoroughly as by the OECD in its Partnership Report released in 1999.

Entities regarded as corporation are themselves liable and subject to tax. Entities classified as partnership are, however, usually seen as fiscally transparent. Instead its partners are considered liable and subject to tax. Therefore, if countries classify the same entity differently, as non-transparent in one country and as fiscally transparent in the other country, they are in conflict regarding the subject of taxation (Gummert et al. 2004). The same applies to entities, regarded in both countries as partnership but treated differently as non-transparent in one country and fiscally transparent in the other country (Gummert et al. 2004).

6.2. The OECD report on partnerships

The OECD report which the Committee on Fiscal Affairs adopted, and decided to make available to the public on 20 January 1999, entitled “The Application of the OECD Model Convention to Partnerships” deals with the application of the provisions of the OECD MTC, and indirectly of bilateral tax conventions based on that Model, to partnerships.

“The Partnership Report states in its examples 13 through 15, that a conflict of qualification between the source state and the state of residence can arise, if in the absence of a treaty definition for a treaty term both states apply differing domestic law to construe the term” stated Professor / Dr. Jürgen
Lüdicke at his public address at Seminar H of the IFA Congress 2008 in Brussels on topic: Decision of German Federal Fiscal Court on Taxation of Interest Payments of a Partnership to a Partner.

The Committee in paragraph 109 of the OECD Partnership Report has also indicated that:

“in addressing conflicts of qualification problems faced by the State of residence, a useful point is the recognition of the principle that the domestic law of the State applying its tax governs all matters regarding how and in the hands of whom an item of income is taxed...When taxing an item of income, the source State therefore applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its conventions. The way the State of residence qualifies an item of income for treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income. The reverse, however, is not true. The way the State of residence eliminates double taxation will depend, to some extent, on how the Convention has been applied by the State of source...Thus the State of residence has a treaty obligation to apply the exemption or credit method vis-à-vis any item where a DTA authorises taxation of that income by the State of source.”

Conflict of qualification can concern two main issues, the first one is qualification of partnerships and the other one is qualification of different types of hybrid financial instruments. When it concerns qualification for partnership, the main issue is how to treat a partnership for tax purpose when two contracting states classify the partnership differently because of domestic law. A partnership could be classified as either transparent or opaque for tax purpose. When two states classify a partnership, according to domestic law or different categories in the double tax convention, it could result in double non-taxation.

Kleist (2012) raises the issue with subject identity in relation to hybrid arrangements. He states that for a double tax convention to be applicable and for it to provide a solution, the tax must be imposed on the same taxpayer. This means that in a conflict of qualification situation, it could be argued that tax is not imposed to the same taxpayer when one contracting state taxes the owner and the other contracting state taxes the entity.

OECD has found that a number of difficulties relating to the application of tax treaties to partnerships fall in the broader category of conflicts of qualification, where the residence and source states apply different articles of the OECD MTC on the basis of differences in their domestic law (OECD 1999). One example below will describe a situation when double non-taxation can arise from qualification conflicts connected to partnerships:

A partnership has its source state in state A. State A does not tax the income because it is state B, the resident state that has the right to tax according to the double tax convention. State B does not tax the income because of domestic law in state B, the partnership is classified as transparent for tax purpose in state B.

OECD points out that a common difficulty is that some states treat partnerships as transparent entities and imposing no tax on the partnership itself but instead tax the owners of the partnership. Some other states treat partnership as a taxable entity which means that the partnership is taxed on its income as if it were a company (OECD 1999). Furthermore, OECD means that this type of conflict
could be solved under Article 23A(4) but that it requires that the tax treaty contains the exemption
method.

Another common situation which could result in double non-taxation is concerning hybrid financial
instruments. OECD presented a report on the area in 2012 and in the report OECD split up different
kinds of hybrid financial instrument and entities (OECD 2012). OECD has defined hybrid financial
instruments as “instruments which are treated differently for tax purposes in the countries involved,
most prominently as debt in one country and as equity in another country.” A hybrid financial
instrument is designed to possess more than one legal form according to the contracting states
domestic law. The hybrid financial instrument has become a mechanism for international tax planning
and is used to take an advantage of the different legal framework in two or more States. Overall,
hybrid mismatch arrangement raises a number of issues. The use of such instruments could distort
competition, effect the economy and fairness in trade (Santos, 2013).

The consequence of a hybrid financial instrument as defined as a mechanism for tax planning, could
for example result in double deductions. With double deduction it is meant that the hybrid financial
instrument created a deduction related to the same contractual obligation that is claimed for income
tax purposes in two different countries. Double deductions could occur both from hybrid financial
instruments and qualification conflicts of partnerships (Jones, 2002).

6.3. Transparent partnership in one State

A related problem arises in connection with whether income of a transparent partnership is treated as
paid to a partner. If there is a difference between the two states in the categorization of the
partnership as transparent or opaque, the OECD partnerships report suggests that the source state
should “take into account, as part of the factual context in which the Convention is to be applied, the
way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer
claiming the benefits of the treaty as a resident.” This is the opposite approach from differences in
categorization of income where the residence state follows the source state’s categorization.

Thus, where the source state treats the partnership in the residence state as opaque and the
residence state treats it as transparent, the source state should follow the residence state’s view and
say that the income is paid to the partners rather than the partnership, thus giving effect to the object
and purpose of the treaty.

The same should apply in the reverse situation where the source state regards the residence state
partnership as transparent and the residence state regards it as opaque: the source state should say
that the income is paid to the partnership, rather than to the partners. However, this solution cannot
apply if the partnership is also in the source state because the source state says that the partners are
entitled to the income arising in that state, while the residence state says that the source state
partnership is entitled to the income. The result is that the treaty is inapplicable.
Hugues Salome and Robert J. Danon in their article ‘The OECD Partnership Report – A Swiss View on Conflicts of Qualification’ quotes John Avery Jones as follows:

“Implicitly, the OECD refers to the suggestions made by Avery Jones and his co-authors contributions. According to these scholars, “the question of categorization of the income applies only to the source State and that State’s determination of the question of how the income is to be taxed is conclusive against the residence State, which must merely satisfy itself that the taxation by the source State is in accordance with the treaty. The state of residence should indeed take the answer to this question for granted and apply the Convention as it affects itself, by exempting or giving credit for the source State’s tax on the income which, may be taxed in the other Contracting State”.

This principle applies in respect of tax suffered in the state of source by a different taxpayer to the taxpayer in the state of residence due to the conflict of qualification. Paragraph 69.2 of the OECD Commentary to Article 23 refers to an example where the State of source treats a partnership as an entity and levies tax thereon and the state of residence of a partner treats it as fiscally transparent and thus levies tax on such partner. The following is noted:

‘the first issue that arises in this case is whether the State of residence, which taxes the partner on his share in the partnership’s income, is obliged, under the Convention, to give credit for the tax that is levied in the State of source on the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that the State of residence flows-through the income of the partnership to the partner for the purpose of taxing him, it must adopt a coherent approach and flow-through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.’

However, if as a result of different rules on the taxability or transparency of a company, particularly in the case of partnerships, a company is liable to tax in one of the contracting states, while its shareholders are treated as taxpayers in the other contracting state, the shareholders should be allowed, even in the absence of any special agreement, to obtain credit for their apportionate (sic) share of the tax paid by the company and vice versa (Vogel, 1996).

Similarly, whether or not a particular entity is a hybrid entity depends on the domestic laws of the countries involved that classify the entities for tax purposes. The taxation of hybrid entities in cross-border transactions has proved to be exceptionally complicated and is perhaps one of the most difficult issues in the application of rules on international tax law.

Some countries, such as Germany, still treat a partnership as an independent entity in some ways. According to that approach, partnerships are utilized as accounting entity, i.e. the income is computed and reported at the partnership’s level where the corresponding accounting elections are applied. In this very respect the partnership is treated ‘as if it were a taxpayer’. The ascertained total profits of the partnership, however, are then to be allotted to the partners according to their respective share of these profits and are eventually taxed only at their level. Procedurally, this is carried out through
section 180 (1) No 2 (a) of the Internal Fiscal Code which ultimately results in a binding assessment of the partners’ shares of the partnership’s profit (section 182 (1) of the Fiscal Code).

Another issue to note is the potential dispute regarding which state is the source state and which state is the residence state. For example, if a partnership has partners in the other state and derives income in the other state and if the partnership is treated in the other state as a non-transparent entity, but as a transparent entity in the partnership state (i.e. in which the partnership has its seat). The partnership state would allocate the partnership’s income to the permanent establishment where the partnership has its seat. The partnership state would, therefore, regard itself as the source state. The other state, however, would regard the partnership state as the residence state since the partnership is, in the view of the other state, non-transparent and thus the taxpayer. The other state would, therefore, also regard itself as the source state.

A dispute about which state acts as the source state and which state acts as the residence state cannot be resolved by an interpretation according to the *lex fori* (i.e. each state applies its tax treaties literally and according its own internal understanding) or the *lex causae* (according to the internal tax system of another state) or by an autonomous interpretation (i.e. according to a system established purely by the treaty itself and its provisions) (Gundisch 2005).

**6.4. Conclusion**

It should be noted that some countries have embarked on introducing provisions within their domestic law to deal with conflict of qualification in their cross-border transactions. For instance, the recently introduced section 50d paragraph 11 of the German Income Tax Act needs to be considered in terms of future payments. This provision was introduced to solve qualification conflicts arising from hybrid entities. Section 50d paragraph 11 provides that in the event of a conflict involving the classification of hybrid entities for tax purposes, the (formal) entitlement of a person to claim a refund of German withholding tax on the basis of a tax treaty shall be determined according to the applicable classification for tax purposes by the other contracting state.
7. INTERNATIONAL INCOME ATTRIBUTION CONFLICTS

7.1. Background

Special problems arise in interpreting treaty terms such as “enterprise”, “business” and “business profits” where those terms are also used in the domestic laws of contracting states, since this may give rise to a qualification conflict. Where both countries to a treaty interpret the meaning of “business” and “business profits” in light of different domestic laws, different distributive rules may be applied to the same income, leading to a qualification conflict (Jones et al. 2003).

Most qualification conflicts in the interpreting the terms “enterprise”, “business” and “business profits” arise as a result of the different treatment of companies by civil and common law countries, since categorization of income is either made by reference to the nature of the income itself (the approach of common law countries, including the UK) or by reference to the taxpayer deriving the income (the approach of civil law countries). However, these differences in approach rarely lead to the application of different distributive rules because of the effect of two provisions in the OECD Model Convention (i) Article 7(7) which addresses the conflict that would otherwise arise from the broad definition of “business profits” and provides that to the extent that income is dealt with separately under another Article of the convention dealing with specific income categories, the provisions of that article should apply and (ii) the deeming provisions in Articles 10(4), 11(4), 12(3) and 13(2) which deem income or gains to be taxed in accordance with Article 7, to the extent that they are effectively connected with a PE in the source state.

In practice, these provisions mean that common law countries will apply the relevant special article (i.e. Articles10,11 or 12) if they determine the activity is not a business activity, whereas civil law countries will start with Article 7, but Article 7(7) will then require the application of the other relevant distributive rule.

The OECD MTC and its Commentaries have since 2000 update contained provisions dealing with “conflicts of qualification”, that is, different categorisation of income by the two states. These differences are particularly likely to arise in relation to whether income is categorised as business profits, certainly the most important type of income. The essence of the difference is that civil law countries treat all the income of a commercial company as business profits, so that the approach in the case of income earned by a commercial company is based on the type of person, while common law countries make the determination according to the type of income. The most obvious example of this difference in approach is that common law countries make a distinction between capital gains and business profits when taxing companies, civil law countries do not, since capital gains are part of business profits (Jones et al. 2003).

7.2. Qualification of income: dividend

A definition of the term “dividends” is provided in Article 10(3) of the OECD MTC. Nevertheless, in view of the great differences between various domestic laws, it is not possible to define the term
conclusively. Therefore, dividends are defined broadly and flexible through several examples, including income from shares and ‘jouissance’ rights. Moreover, reference is made to the domestic law of the source state in order to avoid qualification conflicts between contracting states (Hoor 2010).

When a foreign company (source State) declares a dividend which falls into the definition of Article 10(3) of the OECD MTC, it may then impose tax at the rate set out in Article 10(2). Resident state has unrestricted taxing rights in respect of such dividend, but is generally required in terms of Article 23 to provide a credit against the tax imposed by the source state on such dividend (Stiglingh et al. 2014).

If a foreign company (source state) makes a distribution which, in terms of the domestic law of that jurisdiction, qualifies as a dividend, but which does not fall into the definition of a dividend in Article 10(3) of the OECD MTC then the provisions of Article 7 (i.e. Business profits) of the OECD MTC should apply and the non-resident jurisdiction (i.e. source state) will generally not have any taxing rights in respect of the distribution unless the resident state shareholder operates through a permanent establishment in the source state and the dividend is attributable to such permanent establishment (Stiglingh et al. 2014).

However, it should be noted that the dividend definition in Article 10(3) of the OECD MTC is wide and will cover most distributions on shares. For example, the source state may consider that a dividend is declared when the foreign company makes a distribution from its share premium account. In these circumstances, it is submitted that the source state would have the taxing rights set out in Article 10(2). In these circumstances, resident state would not regard the distribution as a dividend as a matter of resident state domestic law and would tax the distribution in terms of its domestic law. It is submitted that the definition of ‘dividend’ in Article 10(3) of the OECD MTC does not require that the resident state must recognise the distribution as a dividend if such distribution does not constitute a dividend for purposes of the resident state domestic tax law.

Vogel (1996) in his discussion of Article 10(3), states that the definition of ‘dividends’ is primarily of importance to the source state. He further states that it also affects taxation in the state of residence, since it determines, with binding effect on both states, whether or not certain items of income should, under treaty law, be considered to be dividends. Vogel states that this provision differs from Article 3(2), which refers to the domestic law of the state applying the treaty in that it turns the relevant domestic law of the state of source into treaty law and, thus, leaves no scope for any different treaty application by the state of residence.

7.3. Qualification of income: business profits

Article 7(1) of the OECD MTC provides that business profits of an enterprise shall be taxable in the resident state unless the enterprise carries on business in the other contracting state (i.e. source state) through a permanent establishment (PE) situated therein.

A conflict can arise if the residence state considers that there is a PE in the other state but the other state does not. Suppose that a resident of the other state has a presence in the country concerned,
such as an office, then that would be a PE if that concept were relevant. If so, all the income attributed to it is business profits (Jones et al. 2003).

The OECD commentary introduced provisions in the 2000 update to deal with this problem by giving priority to the source state’s categorization of the income. It is suggested that the question is solely one of “qualification” of the income, even though the existence or non-existence of a PE (or the connection of the income to the PE) is also involved, which might be a matter of treaty interpretation.

The question whether there is a PE does not result from any disagreement about whether the definition of PE is met on the facts; rather, it follows from whether the income is treated as business profits in domestic law.

7.4. OECD approach

Despite the design of the OECD MTCL, there are circumstances in which source and residence states may nevertheless apply different distributive rules. However these situations are generally resolved by applying the ‘new’ OECD approach, which was introduced in the Commentary in 2000 (paragraph 32 of the Commentary), and gives priority to the source state’s categorization of the income.

An example of the circumstances in which the application of different distributive rules may occur is where a company resident in a civil law residence state, manages a portfolio of shares through an office in the UK. Although the company is not carrying on a genuine business activity, the residence state is a civil law country and regards all income received by a company as business profits, whereas the UK, as source state looks at the type income earned by the company in order to decide whether it constitutes business profits. The residence state will apply Article 7 and then applies Article 10, which then applies Article 7 via Article 10(4). This is because the residence state considers that the company is carrying on a business of asset management at the office in the source state, which is a PE for tax purposes.

However for the UK there is no PE since it does not apply an “enterprise” fiction, and mere asset management does not constitute a business. Therefore Article 10 will apply and there will be no return to Article 7 via Article 10(4).

The second example, is where the source state is a civil law country and considers all income earned by a company is business income and the UK, as the residence state treats all income according to its nature i.e. dividend income. In this case, the UK will apply Article 10 and the source state will apply Article 7.

In both these cases where different distributive rules are applied, the new OECD approach will avoid double non-taxation (or low taxation) and double taxation. It is suggested that such a dispute is solely one of “qualification” of the income, even though the question whether there is a PE (or the connection of the income to the PE) is also involved, which might be taken to be dispute about the interpretation of the treaty. In the first case, whereas the residence state would normally exempt all
income attributable to the PE (assuming it is an exemption state), since the UK is not entitled to a full taxing right (it will be applying a reduced withholding tax under Article 10) the residence state will instead apply a credit. In the second example, since the source state is exerting a full taxing right, the UK will be obliged to grant exemption. The application of the OECD approach may lead to some countries manipulating their domestic law to ensure that either (i) the definition of “business” in their domestic law is as wide as possible to ensure that income constitutes business profits falling within Art.7, or (ii) where a tax treaty contains a provision equivalent to Art.21(3) of the UN Model (which allows the source country to tax without a PE), to ensure that income from certain sources (e.g. technical fees) does not constitute business profits under domestic law and therefore falls within the “other income” article.

There may be circumstances in which the differing domestic laws of contracting states may lead to double taxation. This may occur where a bank receives interest on the only loan made to a resident of a particular state. Since there is only one loan, there will be no PE. The source state will treat the income as interest income resulting in a withholding tax being charged on the gross interest.

However, if the residence state is a civil law country, it will treat the interest as business profits, and in the absence of a PE will assume full taxing rights over the income. However, the tax deducted in the source state may be too high to be fully credited against the residence country’s tax on net profits (Jones et al. 2003).

Paragraph 49 of the OECD Commentary to Article 23A states the following -

“The combined effect of paragraphs 1 and 2 of Article 10 and Article 23 (Article 23 A and 23 B as appropriate) is that the State of residence of the shareholder is allowed to tax dividends arising in the other State, but that it must credit against its own tax on such dividends the tax which has been collected by the State where the dividends arise at a rate fixed under paragraph 2 of Article 10. This regime equally applies when the recipient of the dividends is a parent company receiving dividends from a subsidiary; in this case, the tax withheld in the State of the subsidiary — and credited in the State of the parent company — is limited to 5 percent of the gross amount of the dividends by the application of subparagraph a) of paragraph 2 of Article 10.”

Through these provisions, the OECD attempts to effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. Many states have recognised this and have inserted in their domestic law provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions (paragraph 50 of the Commentary).

Paragraphs 56.1 – 56.2 of the OECD Commentary to Article 23A(4) provides a solution to a situation in which the source state charges only a withholding tax and the residence state exempts the income, in response to qualification conflict. The purpose of this paragraph is rather to avoid double non-
taxation as a result of disagreements between the state of residence and the state of source on the facts of a case or on the interpretation of the provisions of the Convention.

Paragraph 56.2 states the following -

"The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10 or 11 to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source (see paragraph 34 above). Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of the income that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10 or 11."

Paragraph 56.3 of the commentary on article 23 plays down the significance of the former (i.e. the situation in which the source state charges only a withholding tax) by saying that it is not needed where the exemption is caused by a difference in qualification of the income by domestic law, because this is covered by the latter (i.e. the residence state exempts the income, as explained by the commentary).

### 7.5. Conclusion

The OECD MTC permits the odd combination of a type-of-person approach in the residence state with a type-of-income approach in the source state (i.e. the existence of a PE depends on whether there is a business). This difference in approach is less important if the residence state follows the categorization by the source state in accordance with the Commentary and under new treaties that contain article 23A(4), which prevents exemption from applying.

If the source state does not recognize the existence of a PE it normally makes no difference whether the income is categorized as business profits. Either one starts with article 7 and is sent to another article (or, if the other article is article 10, 11, or 12, one is not returned to article 7 because there is no PE), or one starts in the other article. This is likely to result in a withholding tax being charged even if both states accept that the income is business profits—for example, the bank that makes loans to residents of a state without having a PE there. Such a withholding tax may be too high in relation to the profit on the income to enable full credit to be obtained. One might expect business profits not to be charged to a withholding tax, but that is not the approach of the OECD model convention.

It might be thought that the problem could be solved by defining "business profits" as well as "permanent establishment" in the treaty so that the two would tend to coincide from the point of view of the residence state. But if the treaty definition of business profits is wider than the internal law
definition, there is the problem that the taxation in the source state is by virtue of the narrower internal law, and thus the income still will not always be taxed as business profits.

A better approach might be to ensure that Articles 10(4), 11(4), and 12(3) return one to Article 7 only if the income is in fact subject to tax as profits attributable to the PE. If the income were not subject to tax as business profits, it would remain in article 10, 11, or 12, with the result that the residence state would not exempt the income but would give credit for the withholding tax.
8. INTERNATIONAL CASE LAW

8.1. Background

Tax treaty disputes are also frequently solved through recourse to domestic courts. This is a rather unusual process in the universe of treaties, which are instruments between states. This difference between tax treaties and other treaties can be explained by the fact that tax treaties involve a third party that is absent during the negotiating process, namely the taxpayer, and the conflicting interests of the taxpayer and the states allow the adversarial process to work relatively well, even when the issue must be decided by a court of one of the contracting states.

Below I summarise the existing case law in various jurisdictions, discussing how the courts have attempted to resolve the conflicts of qualification.

8.2. Australia

In *Ostime (HM Inspector of Taxes) v. Australian Mutual Provident Society* (1958) 38 TC 492, the House of Lords held that where there was a clear conflict between the provisions of the Double Taxation Relief (Taxes on Income) (Australia) Order, 1947 and domestic law, the treaty provisions overrode domestic law (Baistrocchi et al. 2012) such that a notional sum of investment income based on a deemed proportion of income from investment of a life assurance fund, constituted “industrial or commercial profits” for the purposes of the Australian treaty. Therefore, the attribution rules in that treaty applied and the House of Lords rejected the Crown’s contention that “industrial or commercial profits” only referred to trading profit. Lord Denning dissented on the basis that the treaty made a distinction between business profits and investment income and under UK domestic tax principles, a mutual assurance company would be making investment, rather than trading income.

8.3. Canada

In *Sun Life Assurance Company of Canada v. Pearson* [1986] BTC 282, the Court of Appeal found that “profits” for the purposes of the Double Taxation Relief (Taxes on Income) (Canada) Order 1967 referred to a Canadian enterprise’s investment income, not its income less expenses. The Court held that while the term “profits” commonly referred to “receipts less expenses”, that interpretation was by no means easily applicable to all businesses and that a wider interpretation of “profits” may be required.

8.4. United Kingdom (UK)

In *General Reinsurance Co. Ltd. v. Tomlinson, H.M. Inspector of Taxes*, the High Court held that enhanced values obtained from sale or conversion of securities from underwriting activities which arose on capital account, may be charged as trading profits of the London branch, where what was done was not merely a realization or change of investment, but an act done in what was the carrying on or carrying out of a business (see also *Northern Assurance Co v. Russell*).
Meanwhile, the Padmore v. IRC case is an example of a conflict between the provisions of a treaty and UK domestic law, which was not accepted by the UK. In response, UK Parliament enacted legislation (Section 58 of the Finance Act 2008) with retrospective effect to intentionally override the effect of Article 7 and ensure that business profits attributable to a person resident in the UK were nevertheless chargeable to tax. The legality of the retrospective effect of this legislation has recently been challenged unsuccessfully under the Human Rights Act 2008 in Huitson v. HMRC [2010] EWHC 97 (Admin).

8.5. Germany

German Federal Fiscal Court rules on qualification of income derived from an US LLC for purposes of the double tax treaty between Germany and the United States. On August 20, 2008, the German Federal Fiscal Court (Bundesfinanzhof) pronounced on the qualification of income for purposes of the double tax treaty between Germany and the United States derived by a German resident individual from a limited liability company (LLC) established under the laws of Florida. This judgement is summarised as follows:

- In order to determine the tax nature (and time of taxation) of income which German resident shareholders/partners derive from foreign entities, it has to be determined whether the distributing entity is treated as a corporation or partnership for German tax purposes.

- Under an applicable double taxation treaty, distributions from foreign corporations are generally taxable in Germany under Article 10 (Dividends) of the applicable treaty, while business profits attributable to a permanent establishment from partnerships are regularly exempt from German taxation under Article 7 (Business Income) of the applicable treaty.

- The German Federal Fiscal Court confirmed that the qualification of an LLC either as a corporate body or a transparent entity (i.e., a partnership) depends on a case by case analysis of the applicable US federal and state company law provisions which regulate the LLC in question and the concrete structural features of the LLC that the shareholders agreed upon.

- This “autonomous” German qualification approach may cause double taxation conflicts where an LLC is treated as a transparent entity for US federal income tax purposes, while Germany assumes predominating corporate features and thus treats the entity as a corporation for German tax purposes. In such case, the US would tax the profits of the (non-US-resident) LLC members at partner level (and, in case of business profits attributable to a permanent establishment in the United States, claim a corresponding taxation right under Article 7 of the Treaty), while Germany would tax the same profits – upon distribution to the members – as a dividend and would also claim a taxation right under Article 21 (Other Income) of the Treaty.

- Because Germany claims the sole taxation right under Article 21 of the Treaty, there is a risk that Germany would regularly not grant any tax credit for US taxes paid by the members on income allocated to them on the level of the LLC.
8.6. Netherlands

From 1997 the Netherlands introduced an exit charge in its income tax law for substantial shareholdings in Netherlands resident companies, in the case of the shareholder’s emigration. The amount of tax due is computed on the basis of the value of the unrealized capital gain during the period of Netherlands residence of the shareholder. The tax charge is made at the time immediately preceding emigration; the collection of tax, however, is postponed until the gain is actually realized by the later alienation of the shares. Collection is no longer pursued after a period of 10 years following emigration has expired.

The taxpayer held 100% shareholding in a company, tax resident in the Netherlands. Upon his emigration from the Netherlands the taxpayer was faced with an income tax charge for the capital appreciation during his period of Netherlands residence, in accordance with the exit taxation of substantial shareholdings. The taxpayer contested the charge, arguing that it was in conflict with the applicable provisions on capital gains in the three tax treaties between the Netherlands and the United Kingdom, Belgium and the United States, respectively, all of which were concluded before the introduction of the Netherlands exit tax.

The Supreme Court decided in all three cases that the provisions of the tax treaties concerned did not prevent the Netherlands exit tax from being levied. It first held that the taxpayer could not, in principle, rely on a tax treaty, since the taxable gain under Netherlands domestic law was deemed to have been derived before his emigration at a time when no treaty was applicable. The Court went on to hold that the exit tax might nevertheless be in conflict with the good faith to be observed in the interpretation and application of tax treaties under Article 31(1) of the VCLT, if a gain were to be taxed that in fact was allocated by a tax treaty to another state. Since the provisions on capital gains in the tax treaties concerned were all modelled on the OECD MTC, the Supreme Court took the OECD Commentaries into consideration for their intended meaning. The Court deduced from paragraphs 2-9, 12 and 29 of the OECD Commentary on Article 13 that the reference to ‘gains’ in Article 13(4) would not preclude a state from deeming as taxable income capital appreciation that is not realized by alienation. In the Court’s opinion the Netherlands exit tax was aimed at no more than taxing the increase in the value of the shares during the period of Netherlands residence of a shareholder, as could be seen, among other things, from the step-up allowed upon immigration to the Netherlands. Therefore, this tax did not breach the required good faith.

The Court did not consider the deemed nature of the gain as conflicting with the tax treaties’ intent, unlike in previous decisions on such other deemed items of income as notional salary (Supreme Court, 25 September 2003, No. 37.651) and notional interest (Supreme Court, 18 June 2004, No. 39.385) as determined in preceding judgements. This could be because OECD Commentaries providing clarifications on such other types of deemed income are lacking as well.

The Supreme Court’s decisions may result in unrelieved double taxation if, when taxing the gain upon its realization by a later alienation, a contracting state does not allow a reduction of the taxable basis.
by the amount previously taxed in the Netherlands (a step-up). Admittedly, the OECD Commentaries point out several cases of double taxation that remains untouched by Article 13. But the present case of unrealized gains is not included. This means that it remains unclear whether such double taxation results from a deficiency in Article 13 or from a wrong interpretation by the Supreme Court. The Supreme Court referred to the step-up that is allowed under Netherlands domestic law, but, in all honesty, this cannot serve as a justification since the OECD Model leaves other states free to compute a gain according to their domestic law and therefore are not obliged to adopt the Netherlands example.

8.7. Belgium

Belgian case law has been consist in upholding that tax treaties should be interpreted in such a way as to avoid double non-taxation. In case of a conflict of qualification between the source state and the state of residence, Belgian courts will rather stick to the qualification provided by Belgian law, even if this leads to double non-taxation. The Belgian tax revenue author also hold the view that in such cases (of conflict of qualifications), Belgium should apply its own domestic qualifications (Morbee 2004).

The judgment of the Brussels Court of Appeal of 24 September 1998 is a striking example hereof. The court ruled that if it is not shown that the context requires otherwise, the Belgian authorities may not apply any foreign provisions, nor qualifications resulting therefrom, in order to conclude that Belgium has the right to tax on the basis of the tax treaty even if this leads to double non-taxation (Morbee 2004).

On retirement, a Belgian resident received French sourced employment benefits from a French employer, as well as from French social security organisation (Assédic). In terms of the French domestic law, the income received qualified as a pension. France therefore concluded that only Belgium (as state of residence) had the right to tax. The taxpayer claimed that Belgium also had to exempt the income in accordance with Belgian domestic law as this kind of income qualifies as salary, which according to the tax treaty is only taxable in the state in which the activity was exercised i.e. France which is the source state. The Court agreed with the taxpayer. The Court also ruled that the interpretation rule provided for in article 22 of the France / Belgium tax treaty (comparable with Article 3(2) of the OECD MTC) might lead to double non-taxation (Morbee 2004).

Although this judgment dates back before the update of the OECD commentary and in spite of the fact that the France / Belgium tax treaty does not follow the OECD model, it shows that the new approach to article 23 is not (yet) supported by Belgian courts. By the way, the Court does not take the OECD recommendation into account either, according to which any interpretation avoiding double taxation or double non-taxation is more desirable than one leading to double taxation or double exemption. Some scholars criticised the judgment for this reason (Morbee 2004).
8.8. Conclusion

The fundamental issue is how the contracting states interpret and apply the tax treaty. Special problems arise in interpreting treaty terms, where those terms are also used in the domestic laws of Contracting States, since this may give rise to conflicts of qualification. This also poses problems for courts on how to interpret and apply treaties properly and consistently.

Another reason why domestic rules of interpretation cannot be solely relied on, is that domestic rules of interpretation of statutes differ from state to state. In civil law countries, only some courts take a literal view towards statutory interpretation. In common law countries like Australia, India, New Zealand, UK, most courts take a literal approach, which is that each word is given its normal meaning without taking notice of any intrinsic material. The literal approach is based on the view that the role of the courts is not to make legislation (including rectifying defects) but merely to interpret legislation. However, more recently, courts in common law countries as well as in South Africa have also applied a so-called ‘purposive approach’ (Honiball & Olivier 2011).

According to Vogel (1996), the mandate to interpret a tax treaty in the light of its object and purposes, leads to the request that states should seek the interpretation of the treaty which is most likely to be accepted in both contracting states, referred to as the ‘rule of common interpretation’. Consequently, according to Vogel, the courts of the one contracting state are obliged to take into consideration and evaluate the merits of relevant decisions of courts in the other Contracting State (Vogel (1996) Introduction 74 39).

In terms of this rule, the foreign court decisions of the other contracting state must therefore have greater value than merely being of persuasive value to a South African court. This interpretation rule is therefore clearly one of the interpretation rules which is peculiar to tax treaty (as opposed to domestic statutory) interpretation. However, the rule of common interpretation does not mean that the court decisions of the other contracting state must be accepted uncritically, without review (Honiball & Olivier 2011).

Neither the administration bodies nor the courts of one country are bound by the administrative or judicial decisions of the other state. Conflicts in the application of the double tax convention will therefore always be possible, which can easily lead to non-intended double taxation as well as double non-taxation (Groen 2002).
9. CONCLUSION

The above obviously raises questions with regard to the resolution of conflicts of qualification. Tax treaties do not usually provide a clear way to resolve a “conflict of qualification” problem. As demonstrated, OECD MTC solutions to qualification conflicts lies primarily in three areas, namely –

- Article 3(2) rule on treaty interpretation;
- Article 23 and its commentary which dictates that resident state must provide relief; and
- Article 25 and commentary which deals with mutual agreement procedures in the event of conflict.

Firstly, what renders OECD Commentaries such important status, in the interpretation of treaties? Understandably, the Model itself and the commentaries are the work of the respective committees of the OECD, which comprise of senior government officials drawn from their respective member countries in consultation with business and other international and regional tax organisations (Gulati 2013), but surely countries will differ in their approach and expectations. Furthermore, the commentaries only set out the informed intentions of the OECD while formulating the articles of their model.

I have highlighted in this study the OECD emphasis on Article 3(2) as a relief for conflicts of qualification. The respected Professor Lang (2001) holds a view that it is rather artificial to resolve qualification problems by interpreting the term application of the Article 3(2) narrowly, leading to source state approach. He argues that there are actually no other arguments supporting this kind of interpretation than the need for a common interpretation. Because the object of common interpretation is not necessarily the object of Article 3(2) the article should not be interpreted to oblige the state of residence to accept the source state interpretation without asking questions. The OECD MTC rather accepts that different interpretations may be reached and therefore Article 25 concerning mutual agreement procedure is included in the Model.

Secondly, double tax treaties are international agreements imposing obligations upon the treaty partner states. Only those states may require the other state to refrain from taxation, to grant a tax credit, or to avoid tax discriminations. It is up to the states to meet the international obligations: they may change their domestic tax laws or give direct effect to the convention in their internal law sphere (Vogel 1996). The effectiveness of Article 23 and its commentary is therefore further questioned.

Each country may also have a general interest in the treaty partner respecting the terms of the treaties negotiated to protect its own economy abroad and to attract the inflow of foreign capital. Binding treaty qualification for the residence state would neither solve the problems nor be a requirement derived from the Model Treaty. Under article 23 of the OECD MC, the residence state is only bound to eliminate double taxation when, according to the treaty, the source state is enable to exercise its tax jurisdiction, giving relief according to the terms of that article (paragraph 32.1 of the Commentary on Article 23). However, application of article 23 does not necessarily imply that in order
to eliminate double taxation the residence state has to mandatorily follow the income treaty classification given by the other contracting state (Prats 2011).

Thirdly, the usefulness of the mutual agreement procedure has been questioned by Runge (2002) as follows:

“...it generally takes a long time and it is the tax authorities that control the procedure; the taxpayer enjoys no particular legal protection. The taxpayer has neither the right to demand a mutual agreement procedure nor to demand the elimination of taxation contravention principles. The taxpayer has no right to be heard or to otherwise involved, and has nor right to be informed of the decision itself or the grounds on which it was taken. Moreover, there is no obligation to disclose the agreement. The absence of the mandatory problem resolution is the largest disadvantage of the procedure.”

The main problem with the mutual agreement procedure is that it is not a binding process. For years, academics have suggested arbitration as a means to resolve disputes arising under tax treaties.

Below I suggest potential solutions to aid in resolving and/or eradicating conflicts of qualification conflicts between contracting states.

9.1. Amendments to domestic law

In relation the question of which contracting state’s domestic law should be applied (i.e. the source or resident state), Vogel (2003) has stated there are three possibilities (i) both states applying the treaty qualify the terms according to the requirements of their own domestic law (ii) both states qualify treaty terms consistently according to the law of the state in which income arises i.e. the source state or (iii) both states seek to establish a consistent qualification from the context of the treaty i.e. an autonomous qualification. Assuming an autonomous interpretation of the treaty term in option (iii) is not possible, and the application of both state’s domestic laws in option (i) results in conflict, the general view is that the law of the state of source should prevail. The residence state may also apply its interpretation. However given the OECD approach, this has not been considered further.

To the extent the contracting states cannot agree on an autonomous meaning of a term from the context of the treaty because the autonomous contextual meaning is unclear, it will be necessary to ascertain the meaning of the term by reference to each contracting states’ domestic tax laws and compare the domestic tax law meanings with the contextual treaty meaning, to the extent one can be derived, to see whether the context otherwise requires. If there is still a qualification conflict caused by the differing application of each state’s domestic laws, the source state qualification should prevail.

In Germany, for instance, under the prevailing interpretation of Article 59 of the Grundgesetz, duly ratified treaties are part of German law and enjoy same status as federal statutes. German courts are bound to interpret domestic law, as far as possible, in a way that avoids the breach of international legal obligations. The role of German courts in the domestic implementation of international treaties appears to be considerable but straightforward: their task is to allow Germany to fulfil its international
obligations by faithfully interpreting German law in accordance with Germany’s international obligations, in particular treaty obligations (Sloss 2009).

It must not be overlooked that the approach already taken by the 2000 Update, which has been confirmed and developed further by the OECD 2008 Update, tries to cure a disease caused by other positions of the OECD Commentary: The OECD has neither abolished the reference to domestic law in Article 3 (2) of the OECD Model nor has made it clear that the phrase “unless the context otherwise requires” should be understood as broadly as possible. The fewer the cases that occur where domestic law is used to interpret tax treaty terms, the greater is the probability that both states will try hard to interpret the treaty in its context, and thereby reach an understanding of a treaty term that can be accepted in common. This would be best to avoid both double taxation and double non-taxation. Of course, it may be burdensome to focus not only on definitions but to achieve interpretation results by taking into account the wording and the history of a provision, its context and its object and purpose. However, making use of the traditional means of interpretation is common to us lawyers whenever we interpret terms of domestic law, which are quite often undefined as well. It is not convincing to forget all our methodology when it comes to the interpretation of tax treaty provisions (Lang 2009).

9.2. Renegotiation of tax treaties

Tax treaties often take years to conclude or to amend. Frequently, a request to fix a minor issue through a protocol leads to a full reconsideration of the whole treaty, which sometimes discourages states from even trying to amend the treaty. This has sometimes led to accusations that tax authorities were attempting to amend their treaties through changes to the commentary because they could not quickly negotiate protocols to their existing treaties. It has also led some countries to enact legislative changes that modify the legal effect of tax treaties under their law (Arnold et al. 2003).

The following should be considered in renegotiating the treaties to avert qualification conflicts:

- Potential remedies to reduce the period of time needed for the conclusion of a treaty renegotiation.
- Ways through which amendments to treaties could be adopted quickly, for example, a regular or multilateral amendment process.
- The competent authorities (i.e. expression normally used by OECD to refer to country’s revenue authorities) should be given some latitude to adapt tax treaties to changing circumstances, potentially through domestic law changes.

On average, tax treaties of OECD countries remain unchanged for 15 years after they are signed or after a protocol is concluded. Compared to domestic law, which is modified almost every year, tax treaties therefore appear immutable. While this guarantees a certain degree of tax stability for taxpayers, it reduces the capacity of a country to adapt its tax treaty network to changing circumstances, including important domestic tax policy changes (Arnold et al. 2003).
9.3. **Enhancing the Status of the Commentary**

As stated above, in most OECD countries, the commentary is regularly used by courts for the purposes of interpreting tax conventions.

The conclusions drawn by the late Justice Graham Hill “from the point of view of a judge of a common law system” can thus be shared by authors coming from a civil law background “I would afford the same status to the commentary on a provision in a model convention as I would to the opinion of textbook writers. Both are informative, but neither is binding. But it would seem a difficult matter, absent any consensus of the contracting states, to regard a commentary after ratification in the same way as a commentary before, if only because the changed commentary was not taken into account by the parties to the treaty before adopting the particular provision” (Lang 2008).

The OECD Committee on Fiscal Affairs (CFA) brings together the tax policy and tax administration expertise of its participating countries (both OECD and non-OECD) allowing its Working parties and Forums to focus on both the evolution of tax policy and on good practice in all the key areas of tax administration. This has proved to be valuable as it is increasingly seen as important to consider the practical administrative implications of new tax laws and policies as these are being developed.

According to paragraph 29 of the Introduction to OECD MTC, the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of member countries; they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions signed by member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes.

Paragraph 29.3 states “Bilateral tax treaties are receiving more and more judicial attention as well. The courts are increasingly using the Commentaries in reaching their decisions. Information collected by the Committee on Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge’s deliberations. The Committee expects this trend to continue as the worldwide network of tax treaties continues to grow and as the Commentaries gain even more widespread acceptance as an important interpretative reference”.

It is therefore essential to that the OECD Commentary be improved and enhanced to decisively deal with conflicts of qualification. This will enhance the value of the Commentary as a tool for treaty interpretation by countries, courts, as well as mere taxpayers.
In my view, a dynamic reference can be justified only if the respective modification of the Commentary has a clarification purpose. However, if there are significant changes to the meaning of the Articles of the OECD MTC or the Commentary, the amendments does not seem reasonable.

9.4. Bilateral Advance Rulings for Tax Treaty Issues

According to EY Guide to advance pricing agreements (APA) (2014), The Advance Pricing Agreement (APA) program allows the taxpayer and the tax authority to avoid future transfer pricing disputes by entering into a prospective agreement, generally covering at least five tax years, regarding the taxpayer’s transfer prices. Taxpayers may enter into APAs with more than one tax authority – i.e., bilateral or multilateral APAs - through the mutual agreement procedure (MAP) included in most income tax treaties.

Bilateral advance pricing agreements (APAs) may be seen as a form of bilateral advance rulings dealing with one treaty issue—that is, transfer pricing. One could envisage extending the APA process to cover all treaty issues. Such extension would constitute a process of pre-dispute settlement of treaty issues.

A number of countries recommend concluding advance pricing agreements with the relevant tax authorities to avoid double taxation from a conflict of qualification. In particular, this is possible in The Netherlands, the US, Germany, Switzerland and Korea. On the other hand, APA are explicitly disallowed in Spain, the UK and Taiwan (Athanas 2000).

9.5. Dispute Resolution

The mutual agreement procedure (MAP) provided for in Article 25 of MTC will often be used to agree upon a common definition of a term. Generally, the rule is that the term be given the meaning which it has in the domestic tax law of the countries.

The Member States of the European Community have decided through their multilateral Arbitration Convention (signed on 23 July 1990) that certain cases of double taxation which cannot be solved through the mutual agreement procedure should be submitted for international arbitration (Schwarz 2009).

The OECD’s Committee on Fiscal Affairs formed a working group to examine ways of improving the effectiveness of the mutual agreement procedure (MAP), including the consideration of other dispute techniques which might be used to supplement the operation of the MAP. In 2007 a final report, ‘Improving the Resolution of Tax Treaty Disputes’ was approved by OECD’s Committee on Fiscal Affairs. This final report includes the following four recommendations (OECD 2007):

- A supplementary dispute resolution mechanism in the form of a mandatory binding arbitration resolution in addition to the OECD MAP considerations;
- Changes in the Commentary of the MAP provision aimed at clarifying and improving various operational and substantial aspects of the MAP process;
A Manual on Effective Mutual Agreement Procedure (MEMAP) as an online resource to explain the MAP process and to describe ‘best practices to effective MAP’; and

Annual reporting by the OECD Member countries of key statistics regarding their MAP case load.

Article 25(5) provides for mandatory arbitration of all issues unresolved under the MAP after two years. The purpose of Article 25(5) is not to replace the MAP with an independent evaluation of the case by a body of arbitrators, but to supplement the procedure in the cases where the competent authorities are unable to agree on the appropriate interpretation and application of a treaty. Once the outstanding issues had been settled by the arbitration, the competent authorities will be in a position to settle the case (Honiball et al. 2011).

Tax authorities, however, frequently reply that the lack of a binding process for solving tax treaty disputes does not matter in practice, as evidenced by the fact that almost all mutual agreement cases between OECD countries are resolved by the competent authorities. They have also argued that the widespread use of arbitration would hamper the mutual agreement procedure since it would lead the competent authorities to refuse to compromise in order to solve disputes at the level of the mutual agreement procedure (Arnold et al. 2003).

The following should be noted in improving the MAP, as well as in dispute resolution mechanisms in cases of qualification conflicts:

- A question of whether the arbitration process should become a feature of tax treaties. Simply put, should contracting States consider an inclusion of provisions dealing with arbitration process in the negotiation of tax treaties? If yes, what should be the characteristics of a tax treaty arbitration process?

### 9.6. International Court of Justice (ICJ)

Under Article 36(1) of the Statute, the ICJ can decide on a matter presented to it by mutual agreement of disputing states. This agreement confers jurisdiction of the ICJ for the specific case. The agreement may even be agreed upon implicitly, when a state accepts appearance before the Court without protest. It is thus currently already possible for tax treaty disputes to be submitted to the ICJ if contracting states involved agree to do so (Zuger 2002).

Under Articles 36(1) and (2), Disputes regarding the interpretation or application of a tax treaty may therefore be unilaterally brought before the ICJ. However, the declaration accepting the ICJ’s jurisdiction may be issued with limitations. States are thus allowed to unilaterally exclude certain topics from the Court’s jurisdiction. Such a limitation is valid with regard to all other states. At present, none of the declarations exclude tax treaty matters (Zuger 2002).

### 9.7. Interpretation of treaty terms
It is generally accepted that the OECD Model Commentary has a significant impact on treaty interpretation. However, there are different views regarding the question of which version of the OECD Model Commentary should be used for treaty interpretation purposes (Schneider et al. 2014).

A difficulty about Article 3(2) has been that some states do not give relief for tax charged by the source state based on its internal law meaning of a term, when the residence state, by applying its law, does not categorize the income as a category that the source state may tax. This view is taken by some exemption states that, as residence states, categorize income to determine whether exemption or credit is to be given; it is not a problem for tax credit states that give credit for all types of income. On this interpretation, Article 3(2) causes the failure to give relief.

The commentary now states that this is not the correct approach. The source state applies its internal law to determine whether the treaty permits it to tax; the residence state gives relief if on this basis the source state is permitted to tax without asking whether it agrees with the source state’s interpretation. The argument in favour of the commentary’s interpretation is that Article 23 does not contain any undefined terms in respect of which Article 3(2) might require reference to internal law. All that it says is that credit or exemption is to be allowed where a resident “derives income . . . which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State.”

The OECD Commentary suggests that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries. Member countries wishing to clarify their positions in this respect could do so by means of an exchange of letters between competent authorities in accordance with the mutual agreement procedure and even in the absence of such an exchange of letters, these authorities could use mutual agreement procedures to confirm this interpretation in particular cases. Apparently, the OECD Committee on Fiscal Affairs assumes that the interpretative value of later Commentary versions can be increased through mutual agreement under Article 25 (3) OECD Model Convention.

According to Article 25 (3) first sentence OECD Model Convention, “the competent authorities of the contracting states shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention”. Such an agreement reached under Article 25 (3) first sentence OECD Model Convention is regarded as a treaty under international law and may thus fall under Article 31 (3) (a) VCLT as a “subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions”.

### 9.8. Subject-to-tax clause

As already mentioned above, double non-taxation may also occur if the income is tax exempt both in the source and the residence state due to diverging domestic tax laws. Such double non-taxation can be avoided through inclusion of subject-tax-clauses. This was recommended by the EU Commission recommendation of 6 December 2012, on Aggressive Tax Planning. Under a subject-to-tax clause a state is only obliged to grant tax treaty benefits if the income is subject to tax in the other contracting state (Schneider et al. 2014).
9.9. **Unilateral interpretative declaration**

In accordance with paragraph 30 of the Introduction to the OECD MTC, each OECD Member States has the right to make an observation if they do not agree with an interpretation prescribed by the Commentary. It can be argued that such an observation may be considered a unilateral interpretative declaration by the state making the observation, reflecting its position at the time a bilateral tax treaty was concluded. The observations ‘usually indicate the way in which those countries will apply the provisions of the Article in question’. In this way, a state does not, by definition, rule out a different interpretation.

The Netherlands has made the following observation to the OECD Commentary regarding qualification conflicts (see paragraph 80 to the Commentary):

“The Netherlands in principle is in favour of solving situations of both double taxation and double non-taxation due to conflicts of qualification between Contracting States, since in the Netherlands view such situations are not intended by the Contracting States and moreover go against the object and purpose of a tax treaty. However, the Netherlands does not agree with the interpretation given in paragraphs 32.4 and 32.6 to the phrase “in accordance with the provisions of this Convention” in Articles 23 A and 23 B of the Convention that in cases of conflicts of qualification that are due to differences in domestic law between the State of source and the State of residence as a rule the qualification given by the State of source would prevail for purposes of the application by the State of residence of Article 23 A or 23 B.

The Netherlands wishes to preserve its right to subject a solution and its modalities for a certain conflict of qualification to the circumstances of the cases at hand and to the relationship with the Contracting State concerned. The Netherlands therefore will adhere to said interpretation in paragraphs 32.4 and 32.6 only, and to the extent which, it is explicitly so confirmed in a specific tax treaty, as a result of mutual agreement between competent authorities as meant in Article 25 of the Convention or as unilateral policy.”

Likewise, Switzerland has made the following observation to the OECD Commentary regarding qualification conflicts (see paragraph 81 to the Commentary):

“Switzerland reserves its right not to apply the rules laid down in paragraph 32 in cases where a conflict of qualification results from a modification to the internal law of the State of source subsequent to the conclusion of a Convention.”

**9.10. Overall conclusion**

This study has highlighted the different views of many scholars and respected academics on relief of qualification conflicts, as well as some of the judicial decisions on such conflicts. As demonstrated there is no ‘fit all’ solution as cases will vary. Qualification conflicts will always arise as they are unplanned, it will take some concrete resolutions between the contacting states, particularly the competent authorities, to craft and improve tax treaties in a manner and spirit of the object of the treaty. The proposed solutions above could only help to anticipate some potential areas of conflicts. These could be included in the drafting and interpretations of treaties.
It is noted that no reference is made in Article 23 of the OECD MTC to any domestic legislation in terms of treaty interpretation. The qualification mentioned by this provision is not made by the state of source but by the treaty rules agreed upon by both contracting states (Lang 2001). Therefore, whether according to these settlements (which are binding for the two parties), the state of source is entitled to tax income of a resident of the other contracting state, both states must provide in their internal tax law some methods to avoid an international double taxation situation. The aim of the reference to domestic law is to oblige states to prevent their residents from double taxation that will probably derive from situations in which, as both parties agreed, the right to tax corresponds to the state of source although the person liable to be taxed is not a resident of this state.
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