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Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization

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Summary

In considering problems of double taxation relief arising from different characterization of income, it is important to eliminate problems caused by the interaction of the treaty with internal law. Many credit states give a treaty foreign tax credit by reference to internal law rules,¹ which usually give credit regardless of the characterization of the income by the source state. Belgium is an exception as it applies its own definitions of dividends, interest and royalties when giving credit, regardless of the treaty definition, and credit is not given where tax is charged by the source state in accordance with the treaty but on a basis of a characterization of income that does not accord with the Belgian definition. Exemption states which also apply exemption under internal law² necessarily characterize income qualifying for exemption in accordance with their own law when applying internal law. Where this characterization is different from the source state's characterization double exemption can occur which normally the treaty cannot cure,³ because the income is exempt in the source state by treaty, and in the residence state by internal law.

Under treaties, exemption states use credit for relieving double taxation on dividends and interest. If the OECD Model Treaty (hereinafter: the Model) is followed, these items of income are identified by reference to the treaty articles containing the definitions of those expressions. The same is commonly true of royalties in treaties. Since dividends, interest and royalties are defined expressions in the Model the residence state is obliged to give credit when the source state taxes in accordance with these definitions which under the Model refer to the source state's law for all or part of the definition of dividends and interest in many treaties. Sometimes exemption states provide for credit for source taxation on additional undefined types of income

identified by reference to the treaty article concerned. In this case we argue that credit has to be given if the source state taxes in accordance with its meaning of the terms, even though these may not correspond to the residence state's definitions in its internal law.

The position is different where relief is given by reference to income by naming the type of income, for example, dividends (without any reference to a treaty article number). This arises normally in the case of relief on dividends from subsidiaries by exemption or by credit for underlying tax, and in tax sparing provisions.⁴ In such cases the residence state will use its own meaning of the type of income which, if different from the source state's, can lead to double exemption or double taxation.

Where no category of income is specified, as is the case for the remaining types of income in an exemption state, and for all types of income in a credit state, relief is required to be given under the Model where income is taxed in accordance with the provisions of the Convention. We argue that there can be only one correct interpretation of what is in accordance with the Convention, and this does not vary according to whether it is looked at from the point of view of the source state or residence state. This is necessarily determined by the characterization of income by the source state. This argument is not generally accepted in all states and we argue that this failure to accept is not a correct interpretation of the treaty.

The argument is stronger in many treaties, which, unlike the Model, state in the relief article that: "double taxation shall be relieved as follows...". Since there is a requirement to avoid double taxation it seems clear that the residence state must follow the source state's characterization.

I. INTRODUCTION

Double taxation, or its opposite, can occur when the two parties to a tax treaty view a transaction differently. This can arise from the categorization of the income into types of income which are treated differently under the treaty, the categorization of the transaction itself, including the application of anti-abuse doctrines, the classification of an entity receiving the income, the identity of the person receiving the income, the source of the income, or the quantification of branch income or income earned in related-party transactions. We shall look here only at the problems caused by the characterization of the income.⁵ If it should be thought from the lack of reported cases⁶ or literature on the topic that the problem does not exist, reference should be made to the OECD Fiscal Committee's Reports on Software⁷ and New Financial Instruments.⁸ The latter report contains the following extreme example of the difficulty in categorizing futures contracts:

Seven countries, Canada, Denmark, Ireland, Norway, Sweden, the United Kingdom and the United States, will apply

1. The common law states, and Belgium and Japan. Switzerland refers to internal law rules but these apply only in cases where the treaty provides for credit.

2. France, Switzerland.

3. There are provisions in some German treaties changing from exemption to credit in these circumstances which are possible because Germany does not give credit under internal law. Some French treaties also contain such a provision which has effect because treaties can increase taxation in France.

4. Occasionally exemption states, such as Germany, refer only to the income qualifying for credit by type, rather than article number.

5. Categorization of an entity may indirectly categorize the income from it but this aspect is not dealt with here as different considerations may apply. Nor do we deal with the situation that each state takes a different view of the facts, resulting in a different characterization of the income.

6. A recent Netherlands Hoge Raad (Supreme Court) case, 25 May 1994, BNB 1994/219, deals with the different problem, that of categorization by the source state where there were two possible ways of taxing a purchase of its own shares by a company, dividends and a special capital gains provision dealing with substantial interests.

7. "The Tax Treatment of Software" in *Issues in International Taxation*, No. 4, (Paris: OECD, 1992); hereinafter: the Software Report.

8. *Taxation of New Financial Instruments*, (Paris: OECD, 1994); hereinafter: The New Financial Instruments Report.

the Business Profits article if the contracts are related to a trade or business, and the Capital Gains article if the contracts are on capital account. In Ireland and the United Kingdom contracts not related to trade or business will be dealt with under the Other Income article if they are of an ordinary income nature. 2 countries, Australia and Japan will apply either the Business Profits or the Other Income article. 5 countries, Austria, Germany, Italy, the Netherlands and Switzerland will only apply the Business Profits article. 2 countries, Finland and France, will only apply the Other Income article. New Zealand and Sweden has (sic) not taken any position to the question.⁹

Given the variety of different characterizations of financial instruments by source states it is not surprising that the residence state may not agree with the source state's characterization. The Software report dealt with the credit and exemption problems arising from differing characterizations of payments for software as business profits, royalties, capital gains and income from independent personal services. Therefore, it is quite clear that differing characterization of income does arise in practice and can lead to credit and exemption problems.

We shall restrict our attention to the question of whether the residence state must give credit or exempt income when it characterizes the income differently from the source state. For example, if the source state taxes an item of income on the basis that it is income from services which it is entitled to tax under the treaty, and the residence state, an exemption state, categorizes the item of income as a royalty which only it is entitled to tax under the treaty, the residence state may tax the income and not exempt it as it would have done if it had agreed with the source state's characterization.¹⁰ The situation is more complicated than merely looking at the category in which the source state taxes the income under its law, as the treaty may reduce or eliminate tax in the source state on the income in a treaty article that deals with income of another type or category. For example, the source state may tax an item of income as being included in business profits under internal law, but under the treaty, in the absence of a permanent establishment, Article 7(7) provides that, say, the interest article is applicable to reduce the tax. In this case the treaty will allow the source state to tax interest included in business profits but limit the tax to the rate of withholding tax under the interest article applied to the gross income. The residence state may also tax the income as business profits, but must respect the treaty classification and give relief for the tax charged on interest.¹¹ This is not likely to give rise to conflicts because interest is a defined expression, but the treaty may place another undefined category of income into a treaty category on which the two states take a different view. We shall consider actual treaty provisions as well as the OECD Model since states do not generally follow the wording of Article 23 of the Model (methods of elimination of double taxation) in their treaties.¹² We shall limit this examination to treaties concluded since 1980 on the grounds that older treaties may not reflect current policy in this area.¹³

II. THE EFFECT OF INTERNAL LAW IN LIMITING THE PROBLEM

A. Treaty reference to internal law credit rules

Unlike the Model, a surprisingly large number of countries make treaty relief subject to internal law relief rules in their treaty double taxation relief articles.¹⁴ This is found in credit articles in treaties entered into by Australia, Belgium, Canada, Germany, Japan, Switzerland,¹⁵ the United Kingdom and the United States of the countries represented by the authors.¹⁶ The reason is presumably that credit provisions already exist in internal law, they are complicated and comprise more detailed rules than can conveniently be contained in a treaty; it is therefore more convenient to cross-refer to internal law rules in a treaty. A reference to internal law provisions makes the question whether credit is given in cases of differing characterization of income primarily an internal law issue, rather than one of treaty interpretation. This does not, of course, mean that the residence state cannot question whether the source state has correctly interpreted the treaty because its law is likely to provide that credit is given if the tax was legally payable in the source state.¹⁷ For example, if the source state categorizes an item of income as interest and charges 10% tax, there is nothing to prevent the residence state saying that the source state has misunderstood the defini-

9. Id., Appendix 1, para. 41. For other categorization problems, see Appendix 1, paras. 18 (interest rate swaps), 70 (options to buy shares) and 104 (deep discount bonds).

10. The example is based on the US case of *Pierre Boulez* 83 TC 584 (1984), in which Pierre Boulez, while a German resident, received payments from US sources for his work conducting an orchestra in the United States for the purpose of making recordings. The question was whether the payments were for personal services, as the US court found, or were royalty payments, as contended by Germany. This question is now dealt with in the 1989 Unites States-Germany treaty by providing in Protocol para. 12 that the income falls within the royalty article. For other examples arising under German law, see Klaus Vogel, "Double Tax Treaties and their Interpretation", *International Tax & Business Lawyer*, Boalt Hall School of Law, University of California, Vol. 4, No. 1, at 61.

11. Another example is that Germany used to tax capital gains on property as business income and did not impose tax in the absence of a permanent establishment or permanent representative. The Netherlands as residence state applied the treaty category as income from immovable property which under the treaty only Germany could tax.

12. Japan follows the Model fairly closely, see the example *supra* note 34, except that it makes the treaty relief subject to the provisions of internal law, as discussed in II. In most treaties each country uses its own relief provisions and references to a country's treaties are to the relief provisions in the treaty affecting that country.

13. We shall include only treaties published before 1 July 1995; in some countries, such as Italy and Japan, treaties are published only when they are ratified or brought into force. Some reference will be made to older treaties where this is necessary to illustrate a point not dealt with in modern treaties. Extracts from treaties are taken from the CD-ROM of tax treaties issued by the International Bureau of Fiscal Documentation and include English translations made by the Bureau.

14. As noted in Article 23B Commentary para. 60. A summary of the methods adopted by OECD countries in giving credit is contained in the OECD report "Attribution of Income to Permanent Establishments", *Issues in International Taxation*, No. 5, (OECD: Paris, 1994), Section II G.

15. In Switzerland these internal law rules apply only when the treaty provides for credit; they are not unilateral credit provisions.

16. The Netherlands also refers in its credit provisions to the amount of the credit being computed in accordance with Netherlands law, but as this relates only to the amount it is dealt with in II B.

17. This point is made in the IFA Canadian National Report by Déry and Ward on treaty interpretation in *Cahiers de droit fiscal international*, Vol. LXXVIIIa, 1993, at 282.

tion of interest and the income should be categorized for treaty purposes as a dividend liable only to 5% tax.

It is a feature of many internal law credit provisions, particularly in the common law countries and Japan, that it is not relevant how the other state taxes the income. The same is therefore true of treaty provisions where the treaty relief is subject to internal law. In such cases the issue whether relief is given in cases of differing characterization is not primarily one of treaty interpretation, although it could become a treaty issue if internal law denied relief or was silent on the question of relief in cases of differing characterization.

Treaty provisions that give relief subject to internal law sometimes say that internal law is not to affect the general principle of the treaty relief.¹⁸ The common law countries all refer to this general principle in their treaties, but use different wording which may have different effects. In Australia and the United Kingdom, as shown in the examples below, the reference to the general principle is worded in a way that allows the taxpayer to claim treaty relief in a case falling within the general principle of the treaty relief, not only if subsequent changes in internal law deny the relief,¹⁹ but also even if internal law in force at the date of the treaty denies relief.²⁰ This means that if the internal law relief is narrower than the general principle of the treaty relief the reference to internal law rules is merely to the rules of internal law providing the mechanism for the relief, including such matters as limitations in the amount of credit.

Australia

Subject to the provisions of *the law of Australia from time to time in force which relate to the allowance of a credit against Australian tax of tax paid in a country outside Australia (which shall not affect the general principle hereof)*, tax paid in Canada,²¹ whether directly or by deduction, in respect of income derived by a person who is a resident of Australia from sources in Canada (not including, in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid) shall be allowed as a credit against Australian tax payable in respect of that income.²²

United Kingdom

Subject to the provisions of *the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof)*:²³

(a) [] tax payable under the law of [] and in accordance with this Agreement, whether directly or by deduction, on profits income or chargeable gains from sources within [] (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the [] tax is computed....

In these cases internal law applies only so long as it does not affect the general principle of treaty relief. However, if internal law relief is more generous than treaty relief, which it is in some cases,²⁴ the fact that, in the United Kingdom, a tax treaty applies "notwithstanding anything in any enactment",²⁵ and, in Australia, the Act giving effect to the treaty has effect notwithstanding anything inconsistent with those provisions in the Income Tax Assessment Act, does not cut down the internal law relief,²⁶ because internal law has priority since the treaty relief is subject to the provisions of internal law.²⁷ Since in both these countries internal law does give relief in cases of differing characterization of income, the issue considered in this article of whether credit would be extended under the treaty does not arise. If internal law, whether or not in force at the date of the treaty, were to deny the relief in cases of differing characterization this issue would arise because it would be a matter of interpretation of the treaty whether credit was required by the general principle of the treaty relief.

In US and Canadian treaties the effect of the reference to the general principle is more limited as it merely governs changes in internal law subsequent to the treaty:²⁸

United States

In accordance with the provisions and subject to the limitations of *the law of the United States (as it may be amended from*

18. See Article 23B Commentary, para. 60.

19. This is expressly stated in Australian treaties by the words *from time to time in force*, but the same must be implicitly the case in the United Kingdom.

20. A UK example is where the treaty provides a deemed source rule that all the income which may be taxed in the other state in accordance with the treaty has a source in that state and is eligible for relief, whereas under internal law, as in *Yates v. GCA International Ltd* [1991] STC 157, only the income for work done in the other state would arise in that state and be eligible for relief.

21. In many Australian treaties there is a requirement that the foreign tax must be paid in accordance with the law of the other state, as in the UK example below. In addition to the treaty with Canada, this requirement is also not contained in the Australian treaties with: Italy (1982), Malaysia (1980) or Switzerland (1980).

22. Australia-Canada (1980). This is standard wording in Australian treaties.

23. This is standard wording in UK treaties. It is generally considered to be ambulatory.

24. For example, United Kingdom-Germany (1964) provides for relief for underlying tax only if the shareholding was 25% of the voting power, whereas internal law provides for relief for holdings of 10% (Taxes Act 1988 (hereinafter: TA 1988), s.790); or if the treaty provides for relief for holdings of 10% but, in some circumstances, internal law provides for relief for a lower percentage (s.790(6)); or internal law deems underlying tax in the other state to include third country and UK tax which the company resident in that state pays (s.801); or underlying relief is given under internal law for second and lower tier subsidiaries, while under the treaty it is given only for first tier subsidiaries; or the treaty denies relief on certain classes of shares, e.g. preference shares, while internal law provides for relief on all classes of shares where the company controls 10% of the voting power in the company (s.800).

25. TA 1988, s.788(3). In fact, these words do not have the effect of cutting down unilateral relief because under internal law the treaty has effect "subject to the provisions of this Part" [of the Taxes Act], and one of such provisions is unilateral relief. Both the treaty and the provisions of internal law giving effect to the treaty are therefore made subject to the internal law relief provisions.

26. If the treaty provides, for example, for a reduced rate of foreign tax, only credit for this can be claimed under the treaty on the basis that the full rate of foreign tax is not in accordance with the provisions of the Convention, see III., and the taxpayer cannot claim unilateral relief for the full rate of foreign tax.

27. See Oliver, "Double Tax Treaties in United Kingdom Tax Law" [1970] BTR 388, 392 on the relationship between internal law and treaty relief.

28. An isolated use by the Netherlands is found in Netherlands-Italy (1990) in relation to the usual Netherlands provision that exemption is computed in accordance with the provisions of Netherlands law, with the addition "which may be subject to modifications without affecting the general principle thereof".

time to time without changing the general principle hereof), the United States shall allow to a resident or national of the United States as a credit against the United States tax on income

(a) the appropriate amount of income tax paid or accrued to the Netherlands by or on behalf of such citizen or resident;....²⁹

Canada

Subject to the existing provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions – which shall not affect the general principle hereof – and unless a greater deduction or relief is provided under the laws of Canada, tax payable in the Netherlands on profits, income or gains arising in the Netherlands shall be deducted from any Canadian tax payable in respect of such profits, income or gains;....³⁰

Unlike the position in Australia and the United Kingdom therefore, there is no independent principle of treaty relief. Internal law and the treaty relief are the same at the effective date of the treaty, and the general principle governs only amendments in the law.³¹ This is explicit in the Canadian provision, which refers to the existing provisions of Canadian law. The same must be true of US treaties since the wording clearly means that the general principle governs amendments to internal law.³² In Canada, the effect of the reference to a greater deduction under internal law, which must mean the law from time to time in force, is that if a modification grants wider relief than the relief existing at the time of the treaty, the wider relief also applies to the treaty. The same is implied by the US provision which gives relief under internal law as amended from time to time, the general principle therefore only preventing a narrowing of the relief. Thus, in the United States and Canada, contrary to the position in Australia and the United Kingdom, if internal law at the date of the treaty did not give relief in cases of differing characterization of income, as it does today, the treaty would not give relief, and so the interpretation of the treaty on this issue does not arise. On the other hand, as in Australia and the United Kingdom, if internal law at the date of the treaty gives relief in cases of differing characterization of income, as is the case today, this can only be taken away if the general principle of treaty relief does not require it to be given, which is the question of treaty interpretation considered in this article.

Japanese treaties also make reference to internal law credit rules but, unlike the common law countries, there is normally no mention of the general principle of treaty relief.³³

Japan

Subject to the laws of Japan regarding the allowance as a credit against Japanese tax of tax payable in any country other than Japan:

(a) Where a resident of Japan derives income from Luxembourg which may be taxed in Luxembourg in accordance with the provisions of this Convention, the amount of Luxembourg tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed

on that resident. The amount of credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income.³⁴

Internal law in Japan also gives relief in cases of differing characterization of income and so no issue of treaty interpretation arises. Japan does not state whether the reference to internal law is static or ambulatory but the general view is that the treaty merely confirms internal law,³⁵ in which case it is ambulatory. If this is the case, the only difference between this and the wording used by the common law countries is that the absence of a reference to the general principle of treaty relief permits Japan to reduce the scope of the relief under the treaty by changing internal law.³⁶

Switzerland is different since, although there are internal law credit rules, they do not apply in the absence of a treaty; they apply only if the treaty provides for credit by reference to internal law, as in the following example:

Switzerland

Where a resident of Switzerland derives dividends, interest or royalties which, in accordance with the provisions of Articles 10, 11 and 12, may be taxed in Australia, Switzerland shall allow, upon request, relief to that person. The relief may consist of:

(a) a deduction from the Swiss tax on the income of that person of an amount equal to the tax levied in Australia in accordance with the provisions of Articles 10, 11 and 12; such deduction shall not, however,

29. United States–Netherlands (1992). The US treaties with Germany (1989) and Spain (1990) and also Netherlands–Italy (see *supra* note 28) instead refer to the general principle *thereof*, meaning of internal law, but since the treaty relief and internal law relief start by being the same and since this is a test of the degree of changes to internal law, there is no difference in meaning. Para. 20 of the Protocol to the United States–Germany treaty defines the general principle: “...the ‘general principle hereof’ (sic) means the avoidance of double taxation by allowing a credit for tax imposed on items of income arising in Germany, as determined under applicable US sources rules, as modified by the Convention. While the details and limitations of the credit pursuant to this paragraph may change as provisions of US law change, any such changes must preserve a US credit for German taxes...”. This makes clear that no difference in meaning is caused by *thereof*, although it seems that *hereof* is intended.

30. Canada–Netherlands (1986). Some older Canadian treaties require the taxation in the other country to be in accordance with the Convention, as in the Model, but this has not been used since Germany (1981), presumably because it is unnecessary in view of the definition of income arising in the other state to mean income which is taxable in the other state in accordance with the Convention.

31. An example of a change which might contravene the general principle of the relief might be the Canadian restriction of the credit on non-business income to 15%, see II.B. Another example are the substantial changes made in the 1995 I.T.A. Amendment Bill (effective 1994) to the definition of active income which has the effect of narrowing the concept of exempt surplus and the cases where exempt dividends will be paid out of exempt surplus and enlarging the cases where dividends will be considered to be paid out of taxable surplus rather than exempt surplus. In the United States a change which limits the credit to 90% in calculating the alternative minimum tax may be another example.

32. Canada has agreed with the US Technical Explanation to the United States–Canada treaty (1980) which does not contain anything to suggest that the rule in both countries is not the same.

33. As an exception, Japan–Hungary (1980) restricts this reference to internal law to the laws in force at the date of signature of the treaty with subsequent modifications which do not affect the general principle, as in the Canadian wording.

34. Japan–Luxembourg (1992).

35. See Y. Komatsu, *Sozeijoyaku no kenkyu* (The Study of Tax Treaties), (1981), at 114.

36. Except in the treaty with Hungary, see *supra* note 33.

exceed that part of the Swiss tax, as computed before the deduction is given, which is attributable to the income which may be taxed in Australia, or

(b) a lump sum reduction of the Swiss tax determined by standardised formulae which have regard to the general principles of the relief referred to in subparagraph (a), or

(c) a partial exemption of such dividends, interest or royalties from Swiss tax, in any case consisting at least of the deduction of the tax levied in Australia from the gross amount of the dividends, interest or royalties.

*Switzerland shall determine the applicable relief and regulate the procedure in accordance with the Swiss provisions relating to the carrying out of international conventions of the Swiss Confederation for the avoidance of double taxation.*³⁷

Internal law provides a credit for tax on dividends, interest and royalties which are effectively subject to tax in the source state *according to the internal law of that state* and to the tax conventions concluded with it. So long as the source state is otherwise acting in accordance with the treaty, for example so long as any recharacterization under thin capitalization rules is in conformity with the arm's length principle, it is the source state's characterization which applies, and Switzerland must give credit accordingly. Again, credit is given in cases of different characterization.

In Belgium, treaty credit is also made subject to internal law, but, unlike the position in the common law countries, Japan and Switzerland, internal law does not provide for relief in cases of differing characterization of income. Accordingly, the treaty does not provide relief in such cases, either.

Belgium

Where a resident of Belgium derives from sources within the United Kingdom:

- (i) dividends dealt with in accordance with paragraph 2 or paragraph 3 of Article 10 of this Convention, not exempted from Belgian tax in accordance with sub-paragraph (c) of this paragraph,
- (ii) interest dealt with in accordance with paragraph 2 or paragraph 6 of Article 11 of this Convention, and
- (iii) royalties dealt with in accordance with paragraph 4 of Article 12 of this Convention,

the fixed proportion in respect of foreign tax for which provision is made under Belgian law shall, under the conditions and at the rate provided for by such law, be allowed as a credit against Belgian tax relating to such income.³⁸

Restrictions on the credit arise where the relief is given for a limited category of income and internal law contains definitions of the categories of income. The official Belgian commentary on tax treaties makes the point that credit for the *quotité forfaitaire d'impôt étranger (QFIE)* under this

type of article is given under domestic law but only if the income is considered to be dividends, interest or royalties under Belgian law.³⁹ This is so even though those terms are defined in the treaty, and even though the treaty credit provision refers to the article dealing with that category of income, because of the express reference to the condition upon which a credit is given under Belgian law which requires the income to be categorized according to Belgian law. Thus, no credit is given for dividend withholding tax at source on a liquidation distribution as this is not a dividend under Belgian law.⁴⁰ The same is true for technical assistance fees which, under a number of treaties,⁴¹ are characterized as royalties and are subject to withholding tax, since such fees are not treated as royalties under Belgian internal law. Also, no credit will probably be given for fees paid to an author for the right to perform a work in public because, although such fees qualify as royalties under tax treaties, they are not considered to be such under Belgian internal law. The reference to internal law is ambulatory⁴² and, as is the case in Japan, there is no limitation by reference to the general principle,⁴³ so that a change in internal law can cut down the treaty relief.

So far, we have considered cases where internal law either specifically does, or does not, give credit in cases of differing characterization of income. A third possibility is that the treaty relief is again subject to internal law, but this time internal law is silent on whether relief is given since internal law deals only with the technique of giving relief. This occurs in Germany:

Germany

Subject to the provisions of *the German tax laws regarding tax credit for foreign taxes*, there shall be allowed as a credit

37. Switzerland–Australia (1980) (our italics). The last words are a reference to Federal Council Decree of 22 August 1967 and 7 December 1981, issued under Law of 22 June 1951 on the prevention of double taxation. Sometimes interest or royalties are treated differently as in Switzerland–Ivory Coast (1987) and Egypt (1987), respectively.

38. Belgium–United Kingdom (1987). Other modern treaties referring to internal law rules are: Bulgaria (1988), New Zealand (1981), Nigeria (1989), Pakistan (1980), Senegal (1987), Sri Lanka (1983), Sweden (1991), Turkey (1987), USSR (1987). In addition, some Belgian treaties, while referring to internal law credit rules, specify a minimum rate of credit which is sometimes higher than the rate of credit under internal law (this is currently as follows: dividends – no credit; interest – credit for the actual foreign tax but limited to 1/5 of the net interest; royalties – lump sum credit equal to 1/5 of the net royalty, regardless of the amount of foreign tax) e.g. Belgian treaties with: China (1985) (minimum 15%), Hungary (1982) (credit not to be given at a rate lower than the treaty rate), India (1974) (minimum 15%), Israel (1972) (minimum 15%), Italy (1983) (same as Hungary), Ivory Coast (1977) (minimum 15%), Portugal (1969) (as Hungary), Singapore (1972) (minimum 15%), Tunisia (1975) (minimum 15%). There are also some older treaties which do not refer to internal law rules at all, e.g. Brazil (1972), Korea (1977), Spain (1970), Indonesia (1973), the Philippines (1976).

39. Chapter 23, paras. 23–124.

40. Liquidation payments from a non-resident company are exempt in the hands of individuals, and the affiliation privilege applies to exempt such payments in the hands of companies provided that the shareholding is at least 5% or the acquisition value is more than BEF 50m. The issue will therefore only arise for recipients which are companies where these limits are not satisfied. Special provisions are contained in the treaties with Luxembourg (1970), former Norway (1967, not in 1988) and former Sweden (1965, not in 1991).

41. Those with Australia (1977), Morocco (1972), Singapore (1972), Tunisia (1975).

42. L. de Bioe, "Kroniek internationaal belastingrecht", *IRV*, 1991, 274; D. Wyntin, "Het nieuwe F.B.B.-systeem en de dubbelbelastingverdragen", *Fiskoloog Internationaal*, 15 February 1991, at 9.

43. Except in the treaties between Belgium and the United States (1970), Ireland (1970) and Japan (1968).

against German income tax, corporate tax and capital tax payable in respect of the following items of income arising in the United Mexican States and capital situated therein, the Mexican tax paid under the Mexican laws and in accordance with this Convention on....⁴⁴

Here the reference to internal law has no effect on the issue under consideration so long as internal law remains silent on the point. The question whether relief is given in cases of differing characterization of income remains one of treaty interpretation which we consider below.

B. Credit provisions affecting the quantum of credit

So far, we have been dealing with the question whether credit is given at all. However, internal law or treaty provisions can limit the amount of credit either by averaging the rates of tax on foreign income, such as in the United States where under internal law foreign income is divided into nine categories or baskets,⁴⁵ or by calculating tax credits for each source separately as in the United Kingdom.⁴⁶ In Canada there is a limit to the credit on non-business income⁴⁷ of 15%, the excess being available only for deduction from the income.⁴⁸ Another example is found in the Netherlands Model Treaty and its modern treaties where reference is made to internal law provisions for the calculation of the amount of credit:

The amount of this deduction from tax is...not greater than the amount of the reduction that would have been granted if the income concerned were the sole item of income exempt from Netherlands tax under the provisions of Netherlands law for the avoidance of double taxation.

Where a Swiss treaty provides for credit, the Swiss internal law requires the foreign-source income to be reduced by interest paid on loans directly connected with the foreign-source income and by any other expenses related to such income and the same occurs in Germany.⁴⁹ Although less common, there can be internal law provisions which affect the amount of foreign tax available for credit.⁵⁰ In all these cases the residence state will apply its own law to categorize the income and the result may be different from that in the source state. Such rules are computational only, affecting the amount of credit, rather than whether credit is given at all, which is the issue considered in this article.

C. Internal law exemption provisions

The effect of the existence of internal law exemption provisions but without any reference to them in the treaty, such as exists in treaties made by France, Italy and Switzerland,⁵¹ is different. Internal law will provide for exemption for certain categories of income which will necessarily be characterized by applying the internal law in the state giving exemption, the residence state. If the application of those provisions leads to double exemption, this will not be prevented by the treaty in the residence state because the income is already exempt before the treaty is applied. An example can be seen of an Italian resident employee working in another country. He is exempt under Italian law regardless of whether the other country taxes the income.⁵² This problem can be avoided only if the

treaty can impose tax, as in France. On the other hand, if in the application of an internal law exemption the residence state categorizes income under its own law in a way that the income does not qualify for exemption which leads to double taxation, there may still be an issue of treaty interpretation whether this is prevented by the treaty if the treaty also provides for exemption. However, it may be the case in practice that some states merely apply the same process as they do under internal law when giving exemption under a treaty.

If a treaty exemption provision gives relief in accordance with the internal law exemption rules, the same problem of double exemption could arise. The Netherlands is the only country represented which includes a reference to internal law rules in its treaty exemption articles generally, but this is merely a reference to the computational rules of internal law.⁵³

44. Germany-Mexico (1993). Other similar German treaties are those with: Australia (1972), Bulgaria (1987), Canada (1981), China (1974), Czechoslovakia (1980), Cyprus (1974), Egypt (1987), Finland (1979), Hungary (1977), Iceland (1971), India (1959), Indonesia (1990), Ireland (dual residence cases) (1962), Jamaica (1974), Japan (1966), Kenya (1977), Korea (1976), Kuwait (1987), Liberia (1970), Malta (1974), Mauritius (1978), New Zealand (1978), the Philippines (1983), Poland (1972), Romania (1973), Singapore (1972), South Africa (1973), Switzerland (1971), Thailand (1967), Trinidad and Tobago (1973), Turkey (1985), USSR ((1981), Yugoslavia (1987), Zambia (1973), Zimbabwe (1988).

45. IRC Section 907(d).

46. Under the normal treaty wording, see text *supra* note 23, credit is given against UK tax charged on the same income which therefore looks at each source separately. The amount of UK tax, which provides a ceiling for relief, is calculated under TA 1988, s.796(2) for income tax and s.797 for corporation tax and see *Collard v. Mining and Industrial Holdings Ltd* [1989], STC 384. The provisions in T.A. 1988, s.798 concerning allocating expenses against foreign income of banks are also relevant to the computation of the credit.

47. Income Tax Act, s.126. This rule does not apply to income from foreign real property.

48. As the reference to the general principle in Canadian treaties relates to the law in force at the time the treaty becomes effective, the restriction imposed is that subsequent amendments are not contrary to the general principle of the credit provisions in force at that time.

49. Federal Council Decree of 22 August 1967, 7 December 1981, Article 11(1). There are also other limitations applicable when the income is subject only to cantonal and municipal tax, or only to federal tax; in the first case a maximum of two thirds of the foreign tax may be credited against the cantonal and municipal tax, and in the second case only one third of the foreign tax may be credited. See, for Germany, BFH decision of 16 March, 1994, *BSI* 1994 II, at 795.

50. For example, in the UK provisions which determine (a) the amount of income arising in the foreign country, (b) the amount of foreign tax in cases where, under the preceding year basis, foreign income is taxed in more than year in the United Kingdom under opening and closing year rules, and (c) the amount of foreign tax for which credit is given in the transition to the current year basis where (normally) half the income of 1996/97 is taxed. In this last case following discussions, the German tax authority agreed that the whole income was subject to tax in the United Kingdom and therefore the full treaty relief for interest, royalties and certain pensions applied in Germany (*Tax Bulletin* April 1995, at 207).

51. Modern Netherlands treaties refer to internal law methods of computing credit or exemption.

52. Article 3(3)(c) CTD. The Central Tax Commission (No. 4934 of 3 July 1990), however, takes the view that the exemption applies only if the income is taxed in the other country.

53. Internal law sets out the mechanics of the relief, such as the carry-forward of excess foreign exempt income and whether the limitation is per country. Swiss treaty exemption provisions permit taking the exempted income into account for the determination of the tax rate applicable to the non-exempted income, which is the same as internal law, without actually referring to internal law.

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However, where a resident of the Netherlands derives items of income which according to articles... of this Convention may be taxed in Canada and are included in the basis referred to in paragraph 1, the Netherlands shall exempt such items of income by allowing a reduction of its tax. *This reduction shall be computed in conformity with the provisions of Netherlands law for the avoidance of double taxation.* For that purpose the said items of income shall be deemed to be included in the total amount of the items of income which are exempt from Netherlands tax under those provisions.⁵⁴

Belgian⁵⁵ and Canadian⁵⁶ treaties also refer to internal law rules in relation to the exemption for dividends from foreign subsidiaries, and Switzerland does so in relation to a partial exemption for dividends, interest and royalties.⁵⁷ These provisions could have the effect of creating double exemption (or reduced withholding tax only) if the source state considered the income to fall within a different category which it could not tax.

D. Summary of categories excluded

Where the treaty refers to internal law for credit rules, and those internal law rules contain provisions which either give relief in cases of differing characterization of income, as in the common law countries, Japan and Switzerland, or, as in the Belgian example, do not give relief, the issue of whether relief is given in cases of differing characterization is primarily not one of treaty interpretation; the issue is merely about internal law.⁵⁸ We can, on the basis of their current law, eliminate the common law countries and Japan in all cases, and Belgium in relation to dividends, interest and royalties from further discussion of the problem of whether credit or exemption is given under treaties in cases of differing characterization of income. The issue could, however, arise in the future in the common law countries which limit the effect of changes in internal law by reference to the general principle of treaty relief. The issue still arises where the treaty refers to internal law but internal law is silent on the question whether relief is given in cases of differing characterization of income, both in relation to descriptive types of income specified in the treaty for credit, as in Germany, and, for exemption, as in the Netherlands. Of course, the issue still arises in all cases where no reference is made in the treaty to internal law relief, as in Italy, the only remaining credit country represented.

Where the application of internal law exemption provisions leads to double exemption, the treaty will not prevent this. If the internal law exemption leads to double taxation, an issue of treaty interpretation can arise as to whether this is prevented by the treaty.

III. THE FORM OF DOUBLE TAXATION RELIEF ARTICLES

It is strictly incorrect to describe a country as an exemption state as there are always some types of income for which credit is granted under an exemption system.⁵⁹ Under the OECD Model, credit always applies to dividends and interest, but in practice this is often extended to other categories of income.⁶⁰ Article 23A of the Model, providing for the exemption method, which among the countries represented is used by Belgium, France, Germany, Switzerland and the Netherlands, is as follows:

1. Where a resident of a Contracting State derives income or owns capital *which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State*, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives *items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State*, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

Under paragraph 2, credit applies to "items of⁶¹ income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State," while under paragraph 1 exemption applies to other items of "income which, in accordance with the provisions of this Convention, may be taxed in the other State". Article 23B of the OECD Model contains wording similar to that in paragraph 1 but applying to all types of income for states adopting the credit method only in treaties, which among the countries represented are the common law countries,⁶² Italy and Japan, as follows:

1. Where a resident of a Contracting State derives income or owns capital *which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State*, the first-mentioned State shall allow:

54. Netherlands-Canada (1986). This is standard wording in modern Netherlands treaties. A variation is found in the treaty with Brazil in which the reference to internal law is limited to the mode of application of exemption.

55. See the examples *infra* at notes 106, 186.

56. See the provision set out in the text *infra* at note 187.

57. See the example *supra* at note 37.

58. See text *supra* at note 17 for a discussion of when the issue involves treaty interpretation.

59. And conversely, as Article 19 Commentary para. 2 points out, Article 19 contains an exemption provision applicable to states normally using the credit method.

60. The Commentary also recommends using the credit method under an exemption system in cases where the source state does not have the right to tax income of artistes and sportsmen under its internal law in accordance with Article 17(1) or (2): Article 17 Commentary para. 12.

61. The words *items of* were new in the 1977 Model. They were, however, used in Article 21 of the 1963 Draft.

62. Australia exempts income attributable to a permanent establishment in a listed country, and non-portfolio dividends paid to an Australian-resident company, and Canada exempts dividends received out of the exempt surplus of a foreign affiliate, but both countries provide for exemption in treaties only in a way which permits the internal law exemption to continue to apply.

a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State....

IV. CREDIT PROVISIONS IN EXEMPTION STATES' TREATIES WHICH REFER TO SPECIFIC TYPES OF INCOME

In this section, we shall consider the application of Article 23A(2) where credit is given for tax on specific types of income, which has no equivalent in Article 23B. Provisions modelled on Article 23A(2) are often in practice wider than the OECD Model's categories of dividends and interest, both of which are defined terms. In V. we shall consider Articles 23A(1) and 23B, in which credit for, or exemption from, tax is given without specifying any type of income, on income which may be taxed in the other state in accordance with the Convention. In Article 23A(2) the categories of income for which credit is given are normally specified; exemption is given for the remaining undefined categories of income. However, there are cases, such as exemption for intercompany dividends⁶³ and for all types of income qualifying for exemption in Netherlands⁶⁴ treaties, where categories of income are also specified in the exemption provision. Exactly the same considerations apply in these cases, but for simplicity we shall refer to characterization of income only for the purpose of giving credit. Suppose a state which gives both credit and exemption under its treaties gives credit for tax on an item of income which is undefined,⁶⁵ the question arises whether the residence state applies its own characterization rules to determine whether the item of income is eligible for credit. There are three possible ways the treaty can specify the type of income qualifying for credit: by article number (as in the Model's "items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State..."),⁶⁶ by naming the descriptive type of income in addition to the article number ("dividends within the meaning of Article 10..."), and by descriptive type of income alone ("dividends").⁶⁷ We shall consider each of these in turn.

A. Category of income specified by article number

The OECD Model uses the method of referring to the article number to determine that the residence state must give credit for tax on "items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State,"⁶⁸ thus clearly bringing into effect the definitions of dividends and interest contained in those articles. The definition of dividends in Article 10 contains a reference in part to the internal law of the state of residence of the paying company, the source state.⁶⁹ Often states make reference to the source state's internal law in the definition of interest in the interest article.⁷⁰ In relation to interest charged at an excessive rate, Article 11(6) specifies that taxation is to be in accordance with the source state's law.⁷¹ While any charge to tax will be in accordance with Article 11, the income may not be charged to tax as interest, which could still give rise to problems about relief.⁷²

The Netherlands and France⁷³ specify the categories of income qualifying for credit (and also for exemption in the Netherlands) by article number,⁷⁴ as in the OECD Model, but the list is wider than in the Model. The issue of whether credit (or exemption) is given in cases of differing characterization under this method of specifying the category of income can therefore arise with terms not defined in the treaty only in these two countries out of the countries represented:

63. See IV C.2 for examples.

64. Other examples can be found in France-Kuwait (1982) and France-Saudi Arabia (1982) where article numbers refer to categories of income qualifying for exemption, and credit applies in the residual case.

65. This includes the case where an item of income is defined for the purpose of only one article of the treaty, such as the definitions of dividends, interest and royalties, unless there is an express reference in the double taxation relief article to the article containing the definition, as there is in Article 23A(2) of the Model.

66. This is the method used by the Netherlands and France.

67. This is the method normally used by Belgium and Switzerland, which restrict credit to dividends, interest and royalties, and by Germany, which gives credit for additional items of income.

68. Article 23A(2). Paragraph 47 of the Commentary on Article 23B in dealing with the interpretation of Article 23A(2) makes no distinction between specified and unspecified categories of income, but it should be noted that the only specified categories are the defined categories of dividends and interest.

69. See the discussion in the text *infra* around note 111.

70. Article 11 Commentary para. 21 permits states to do this. The 1963 OECD Draft included such a provision in the definition of interest and there are many treaties still in existence which follow this definition. In modern treaties, *Australia* and *Canada* include in the treaty definition of interest: "as well income assimilated to income from money lent by the taxation law of the state in which the income arises" (or similar wording) in about 31 and 46 treaties, respectively. Only in *Canada's* treaties with Cameroon (1982), China (1986), Germany (1981), and Norway (1966) is there a definition of interest which does not refer to internal law. The treaties with New Zealand (1980), Denmark (1955) and Trinidad and Tobago (1966) have no definition of interest but the equivalent of Article 3(2) of the Model would have the same effect as a specific reference to internal law. *Italy* makes reference to internal law in the definition of interest in about 53 of its treaties. *Germany* does the same in about 37 of its treaties. There are a considerable number of *UK* treaties making reference to internal law in the definition of interest but these are mostly before or around the time of the 1977 Model; the only post-1977 treaties which do so are those with: Bangladesh (1979), Belgium (1987), Canada (1978), Czechoslovakia (1990), Gambia (1980), Italy (1988), Ivory Coast (1985), Morocco (1981), Sri Lanka (1979), Thailand (1981), Tunisia (1982), Turkey (1986) and Yugoslavia (1981). In the other states represented there are only a few post-1977 Model treaties referring to internal law for the definition of interest such as are those between *Belgium* and: Canada (1975), Italy (1983), Korea (1979), Turkey (1991), United Kingdom (1989); *France* and: Austria (1993), Italy (1989), Korea (1979), New Zealand (1979), Quebec (1987), Turkey (1987), USSR (1985); *Japan* and: Canada (1987), France (1981), Singapore (1981), and Thailand (1990); the *Netherlands* and: Brazil (1990), Canada (1986), the Philippines (1989), Italy (1990), Yugoslavia (1982), former USSR (1986), the United States (1992); *Switzerland* and: Australia (1980), Canada (1976), Greece (1983), Indonesia (1988), Ireland (1980), Korea (1980); United States and: Australia (1982), Bangladesh (1980), Canada (1980), Cyprus (1984), Egypt (1980), Germany (1989), Portugal (1994), Sri Lanka (1985).

71. This provision is discussed at IV A.1.c.

72. There may be other difficulties, such as different views about who is the payer, as in the Canadian provision which deems the proceeds of sale of the shares of one Canadian company to another to be a dividend paid by the acquiring company, see *infra* note 99.

73. Sometimes French treaties provide for credit only in which case this characterization issue does not arise: e.g. French treaties with: Bulgaria (1987), Congo (1987), Ecuador (1989), Iceland (1990), Italy (1989), Nigeria (1990), Oman (1989), Qatar (1990), Sweden (1990), Turkey (1987), United Arab Emirates (1989).

74. The same is true of some older Belgian treaties, e.g. Greece (1968), Israel (1972), Japan (1968), Portugal (1969), Spain (1970), Tunisia (1975), but modern Belgian treaties refer both to the category of income and the article number, see IV B.

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... where a resident of the Netherlands derives items of income or owns items of capital which according to Article 6, Article 7, paragraph 4 of Article 10, paragraph 3 of Article 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 13, Article 14, paragraph 1 of Article 15, paragraph 3 of Article 18, paragraphs 1 (sub-paragraph (a)) and 2 (sub-paragraph (a)) of Article 19 and paragraphs 1 and 2 of Article 23 of this Convention may be taxed in Sweden and are included in the basis referred to in paragraph 2, the Netherlands shall exempt such items of income or capital by allowing a reduction of its tax....

Further, the Netherlands shall allow a deduction from the Netherlands tax so computed for the items of income which according to paragraph 2 of Article 10, paragraph 5 of Article 13, Article 16, Article 17 and paragraph 2 of Article 18 of this Convention may be taxed in Sweden to the extent that these items are included in the basis referred to in paragraph 2.⁷⁵

France

Income mentioned in Articles 8, 10, 11, 12, 14 and 15 arising in Sri Lanka and received by a resident of France is taxable in France. A tax credit is granted on the following conditions:....⁷⁶

The problem arises when the source state taxes income, within a specified article number which does not contain a definition of that category of income, by applying its own definition of that category of income, while the residence state, also applying its own definition, considers that the source state should not have taxed the income but should have exempted it (or applied a reduced rate of withholding tax) and, accordingly, does not give credit for the source state tax. If the residence state is an exemption state it may consider that the income falls into a category which it should exempt because such income is fully taxable in the source state, but the source state may impose limited taxation by way of withholding tax, leading to only a reduced tax being charged in the source state. We shall next consider statements about this issue in the OECD Commentary and other OECD reports, writings of other authors, the arguments for allowing relief and what the countries represented do in practice.

1. The OECD Commentary

a. *Thin capitalization*

Where there is thin capitalization, interest paid by a company in some source states⁷⁷ (the state of residence of the company) may be recategorized as a dividend under internal law. We shall assume, in accordance with the clarification to the Commentary made as a result of the OECD Thin Capitalisation Report,⁷⁸ that such income qualifies as a dividend for withholding tax purposes.⁷⁹ If, in an exemption state, credit is required to be given for items of income which, in accordance with the provisions of Article 10, may be taxed in the other Contracting State, one would expect that credit has to be given for dividend withholding tax on the interest recharacterized as a dividend. The Com-

mentary's⁸⁰ statement about relief in cases of thin capitalization is difficult to understand. It is worth setting out the provision in full:

If the relevant conditions are met, the State of residence of the lender would be obliged to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend. It should then give credit for tax effectively withheld on this interest in the State of residence of the borrower at the rate applicable to dividends.... This obligation may result:

- (a) from the actual wording of Article 23 of the Convention, when it grants relief in respect of income defined as dividends in Article 10 or of items of income dealt with in Article 10;
- (b) from the context of the Convention i.e. from a combination of Articles 9, 10, 11, and 23 and if need be, by way of the mutual agreement procedure.
 - where the interest has been treated in the country of residence of the borrower as a dividend under rules which are in accordance with paragraph 1 of Article 9 or paragraph 6 of Article 11 and where the State of residence of the lender agrees that it has been properly so treated and is prepared to apply a corresponding adjustment;
 - when the State of residence of the lender applies similar thin capitalization rules and would treat the payment as a dividend in a reciprocal situation, i.e. if the payment were made by a company established in its territory to a resident in the other Contracting State;
 - in all other cases where the State of residence of the lender recognises that it was proper for the State of residence of the borrower to treat the interest as a dividend.⁸¹

75. Netherlands-Sweden (1991); the article numbers follow the OECD Model up to Article 19 and then there is an additional Article 20 on professors and teachers, after which the article numbers are one higher than in the Model. This is the same as the double taxation relief article in the Netherlands Model Treaty.

76. France-Sri Lanka (1981). The articles referred to relate to: shipping, dividends, interest, royalties, directors's fees, and artistes and athletes, respectively. This wording is typical of modern French treaties, except for the treaties with Bulgaria (1987), Congo (1987), Ecuador (1989), Oman (1989), Qatar (1990), Turkey (1987) and United Arab Emirates (1989) which provide only for credit; and Kuwait (1982) and Saudi Arabia (1982) which list the categories qualifying for exemption, rather than credit.

77. For example, Belgium, Germany, Switzerland, the United Kingdom (strictly it is treated as a distribution, not a dividend, but normally treaties define dividends to include distributions, although credit problems will not arise as there is no internal law withholding tax on dividends) and the United States. There is no thin capitalization concept in the Netherlands, but see *infra* note 101.

78. "Thin Capitalisation", *Issues in International Taxation*, No. 2, (Paris: OECD, 1987); hereinafter: the Thin Capitalisation Report), paras. 51-54, 56-60. See now Article 10 Commentary para. 25 (the History at the end of Article 10 Commentary states that this paragraph is derived from the Thin Capitalisation Report) and Article 23 Commentary para. 67. The only way in which the recharacterized interest is within the definition of *dividends* is that it is "income from other corporate rights", which a majority of members of the Fiscal Committee considered was the case. See para. 56 of the Thin Capitalisation Report.

79. A difficulty (which a majority of the OECD Committee on Fiscal Affairs did not see as impossible to overcome: para. 56 of the Thin Capitalisation Report) about deciding whether interest characterized as a dividend falls within Article 10 is the exclusion of income from debt-claims in the definition of dividends.

80. This passage is new in the 1992 Commentary.

81. Article 23 Commentary para. 68. Although this is part of the Commentary to the credit method in Article 23B it is equally applicable to para. 2 of Article 23A dealing with the exemption method, see Article 23 Commentary, para. 47.

As this is a Commentary to the Model one would expect it to explain the meaning of the Model's wording, and one would expect it to say clearly that credit must be given in thin capitalization cases since the source state is taxing what is a dividend within the definition in Article 10. Why then does item (a), while referring to Article 23, deal with two sets of wording not contained in the Model ("income defined as dividends in Article 10," and "items of income dealt with in Article 10"), instead of the Model's wording "items of income, which in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State"? Even more confusing is the existence of item (b) which is an indication that there are states which do not accept that credit should be given in all cases where the application of thin capitalization rules categorizes the interest on the excessive amount of debt as a dividend, even though the definition of dividends includes "income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident". One possible reason for the existence of item (b) may be that it was only a majority of the Fiscal Committee who agreed that these words included interest recharacterized under internal law as a dividend as a result of thin capitalization provisions, in the light of the exclusion of income from debt-claims earlier in the definition;⁸² but this does not seem to be the case as the conclusion that credit should be given in such cases under articles equivalent to Article 23 of the Model is stated to be that of the Committee and not merely a majority conclusion.⁸³ This reference to the context and to the mutual agreement procedure in item (b) dealing only with three specific cases does not seem to relate merely to the possibility that the treaty partners may need to communicate in order to agree on the amount of arm's length debt, which clearly might be necessary in relation to item (a) as well. The Commentary therefore apparently admits that the Model might fail to prevent double taxation in cases of differing characterization of income, even in relation to the defined expression dividends, the definition of which points to characterization by the source state (the state of residence of the company), when the prevention of double taxation is one of the most important objects of the Model.⁸⁴ It might be expected that, if this is the position for a defined category, dividends, which refers to the law of one of the states, where there is a reference to an article containing an undefined category of income, the residence state is even less likely to be required to give credit for tax on income which the source state, but not the residence state, considered to fall within that article.

The real explanation, however, for this paragraph of the Commentary is that it is derived from the Thin Capitalisation Report⁸⁵ in which it served a different purpose. This Report made a distinction between (i) articles equivalent to Article 23 of the Model, including those containing such wording as "income defined as dividends in article 10" or "items of income dealt with in article 10," when credit should be given so long as the thin capitalization rules conformed with Articles 9, 10 and 11 of the Model;⁸⁶ and (ii) other, differently-worded, credit articles which gave credit for tax on dividends without referring to Article 10 and without defining dividends for the purpose of

the credit provision, when credit should be given in the three cases set out above by virtue of the context or under the mutual agreement procedure.⁸⁷ In relation to item (i) the Report states:

When by the application of its national rules about thin capitalization, the country of the borrower has assimilated a payment of interest to a distribution of profit, the country of the lender would in certain circumstances⁸⁸ clearly be obliged under particular bilateral treaties, as the result of a combination of Articles corresponding generally to Articles 10 and 23 of the Model, to give relief from any juridical or economic double taxation of the interest as if the payment was in fact a dividend (such as credit for tax withheld at the source at the rate appropriate to a dividend and, possibly, application of a parent/subsidiary regime).⁸⁹

There is a reference back to the earlier discussion in the Report which deals with reliefs under an article equivalent to Article 23 of the Model, including articles using the expressions "income defined as dividends in Article 10" or "items of income dealt with in Article 10".⁹⁰ It seems clear that credit should be given under such treaty wording in relation to the source state's thin capitalization rules, if they conform with the provisions of Articles 9, 10 and 11 of the Model (i.e. conform with the arm's length concept), even if the residence state does not itself consider that the payment of interest is a dividend. In other words, item (a) in the quotation from the Commentary was considered sufficient to deal with credit in all thin capitalization cases on the Model's wording, and in two other cases of similar wording.

In relation to item (ii) containing wording which is different from the credit provision of the Model which merely refers to "dividends" without any reference to an article number, the Report says this:

If the text of the relevant Article [dealing with credit] simply gave relief in respect of 'dividends' without referring to Article 10, and if there was no generally applicable definition of dividends elsewhere in the relevant bilateral treaty, the meaning of 'dividends' for this purpose *would depend on the domestic law of the country of residence of the lender*, which would not necessarily accept any extended definition of 'dividends' provided by the thin capitalization rules of the country of the paying company.⁹¹

82. Thin Capitalisation Report, para. 56. The reservations to Article 10(3) in Article 10 Commentary, paras. 78 to 81.1, many of which seek to include certain interest within the definition of dividends should be noted.

83. See *supra* note 78, para. 64, cf. para. 56.

84. See Article 1 Commentary para. 7: "The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons...."

85. The History at the end of Article 23 Commentary states that para. 68 is derived from the Thin Capitalisation Report (see *supra* note 78), para. 86.

86. See *supra* note 78, paras. 64 and 86(a). This wording is similar to, but not the same as, the Model's "in accordance with the provisions of Article 10". It is odd that the Model's wording is not specifically covered.

87. See *supra* note 78, paras. 65 and 86(b). Articles in this form are less common, but see IV C. for examples.

88. This seems to be a reference to para. 57 of the Report dealing with the circumstances in which it is appropriate to treat loans as capital, that the funds are subject to the hazards of the business. This is the case when there is thin capitalization.

89. See *supra* note 78, para. 86(a).

90. See *supra* note 78, para. 64.

91. See *supra* note 78, para. 65 (our italics), and see also the conclusion in para. 86(b). For examples of such treaty wording, see IV C.

This statement looks to the *residence* state's internal tax law meaning of dividends, obviously on the basis of Article 3(2), under which undefined terms in the treaty have the meaning which they have under internal law for the purposes of taxes to which the Convention applies,⁹² but goes on to consider that relief should be given in the three cases set out in item (b) in the quotation from the Commentary above, either on the basis that the context otherwise requires that the residence state's definition should not be used,⁹³ or by mutual agreement in order to attain the principal object of the treaty, the avoidance of double taxation.

When the Thin Capitalisation Report was incorporated into the Commentary, these latter comments, which did not relate to the Model's wording, wrongly, in our view, became part of the Commentary to the Model.⁹⁴ The Commentary, as a result, now appears to say the opposite of what was contained in the Thin Capitalisation Report, that credit should be given in the case of wording following the Model, because the presence of item (b) suggests that there are cases where the Model avoids double taxation only in the circumstances listed. It is suggested that this part of the Commentary should not be read in the normal way as a Commentary to the Model, and that it should be interpreted by considering its origins in the Thin Capitalisation Report. On this basis, the Commentary contains a clear statement in item (a) that, on the Model's wording, relief from double taxation must be given in thin capitalization cases, where a defined term, dividends, is concerned.

Where the interest is recharacterized by the source state as a dividend, credit is given for the dividend withholding tax in Australia,⁹⁵ France, Italy, Japan, Switzerland,⁹⁶ the United Kingdom and probably the United States. Canada gives credit for the dividend rate of withholding tax, while still taxing the income as interest, rather than exempting it as a dividend.⁹⁷ The credit is limited to 15%.⁹⁸ No credit for dividend withholding tax on interest recharacterized by the other country would probably be given in Belgium for the reason given in II. The point is uncertain in Germany and the Netherlands, but, in the latter, credit would probably be given if the interest qualified as income from other corporate rights which is subjected to the same taxation treatment as income from shares in the definition of dividend. In many treaties, the case for giving credit is strengthened by changes to the treaty definition of dividends, such as dividends including income assimilated to income from shares, or provisions dealing with thin capitalization.

In addition to thin capitalization, other internal law provisions can deem payments to be dividends. There are provisions of Canadian law which deem the proceeds of sale of shares of one Canadian company to another to be a dividend paid by the acquiring company in an amount equal to the excess of the proceeds of sale over the paid-in capital.⁹⁹ The residence state of the seller would probably categorize the transaction as one giving rise to a capital gain based on the difference between the cost and the selling price (which may be different from the excess of the selling price over the paid-in capital). It is suggested that the residence state must accept the Canadian treatment as a divi-

dend and give credit accordingly because the Canadian charge is within the definition of dividend, being "income assimilated to income from shares by the taxation laws of the State of which the company making the distribution is a resident," which is the wording Canada includes in the definition of dividends in Article 10 of its treaties.

Under the thin capitalization rules of some countries the interest is merely disallowed as a deduction in computing profits without being treated as a dividend for withholding tax.¹⁰⁰ This occurs in Australia, Canada, France and the Netherlands.¹⁰¹ In these cases no credit problem will arise in the residence state because interest withholding tax will be charged by the source state and the residence state will agree that it is interest.

Another issue relating to thin capitalization is whether reliefs under a parent/subsidiary regime, such as credit for underlying tax or exemption, is given on interest recharacterized as a dividend. This does not arise under Article 23 of the Model but may arise in accordance with unilateral or treaty provisions which states are free to adopt in accordance with the Commentary.¹⁰² The Thin Capitalisation Report states that these provisions should be applied to interest recharacterized as a dividend under thin capitalization provisions in accordance with Articles 9, 10 and 11

92. Article 3(2) is considered in IV.A.4 a. and V.A.

93. The Report does not mention the context but it is referred to in Article 23 Commentary para. 68(b).

94. The problem may have been caused by the conclusion in para. 86 of the Thin Capitalisation Report starting: "As regards Article 23 of the Model and certain additions to that Article which appear in a number of bilateral treaties..." without specifying which part of the conclusion related to the wording of the Model.

95. The Australian Model Treaty and most of its treaties define dividends in the dividend article to include income assimilated to income from shares by the tax law of the source state, which makes it clear that the recharacterized interest is a dividend.

96. On the assumption that the recharacterization is in accordance with the provisions of the treaty, as being income from other corporate rights which is subjected to the same taxation treatment as income from shares in the definition of dividend in Article 10(3), and so long as the recharacterization is in accordance with the arm's length principle: see Daniel Lüthi, "Die Unterkapitalisierung von Kapitalgesellschaften im internationalen Steuerrecht", *Das Schweizerische Steuerrecht, Eine Standortbestimmung, Festschrift zum 70. Geburtstag von Prof. Ferdinand Zuppinger* (Bern: 1989), at 573 et seq.

97. The difference is material because dividends paid by a foreign affiliate are exempt in the hands of a corporate recipient in Canada, whereas interest will be taxable. This exemption is contained in the Canada-United Kingdom treaty (1978) in relation to *any dividend* but it is considered that the definition of dividend in the dividend article ("the term 'dividends' as used in this Article...") would not apply to the interpretation of the elimination of double taxation article particularly because only through the application of provisions of the internal law of Canada can one determine to what extent a dividend is received by a company resident in Canada out of exempt surplus of a foreign affiliate resident in the United Kingdom, and under such internal law, a payment of interest does not result in a dividend paid out of exempt surplus.

98. See *supra* note 47. If there is interest expense in borrowing money to make the investment, the credit is limited also to the Canadian tax payable on the net income.

99. ITA s 212.1. There are similar rules in the United States in IRC Section 304.

100. In the United Kingdom the excess interest is treated as a distribution which is non-deductible. The treaty definition of dividends usually includes distributions, but there is no withholding tax on dividends under internal law.

101. There is no thin capitalization concept in the Netherlands, but in some circumstances a lender may be found to "participate to a certain degree in the business of the borrower (Hoge Raad decisions of 5 June 1957 BNB 1957/239, 3 March 1993, BNB 1993/141).

102. Article 23 Commentary paras 49 to 54.

of the Model.¹⁰³ The conclusion section of the Report quoted at item (i) above is, however, less definite in merely stating that the regime should possibly apply.¹⁰⁴ No interpretation issue arises in states which give relief unilaterally, as do France, Italy and the Netherlands. Belgium provides in its treaties for exemption for intercorporate dividends in these circumstances, unusually referring to dividends within Article 10.¹⁰⁵

Where a company which is a resident of Belgium owns shares in a company with share capital which is a resident of Norway and which is subject to Norwegian tax on its profits, the dividends which are paid to it by the latter company and which may be taxed in Norway in accordance with paragraphs 2 or 3 of Article 10, shall be exempt from the corporate income tax in Belgium to the extent that exemption would have been accorded if the two companies had been residents of Belgium.¹⁰⁶

The official commentary on tax treaties issued by the Belgian tax authority states that under the treaties with France and the United States exemption is given on such recharacterized dividends.¹⁰⁷ It is thought that the same would apply under other treaties referring to dividends within Article 10. Most other countries refer in similar treaty provisions to dividends without any reference to Article 10, and such provisions are considered in IV.C.

b. Liquidation distributions

Problems of credit for differing characterization of income can arise where the source state has taxed a liquidation distribution as a dividend,¹⁰⁸ but under the residence state's law the liquidation gives rise to a capital gain which, from its point of view, the source state should not have taxed and only the residence state should tax.¹⁰⁹ The treaty issue in the residence state is whether the item is "income which, in accordance with the provisions of Article 10, may be taxed in the other Contracting State". The Commentary¹¹⁰ states that where a liquidation distribution is taxed as a dividend it is income which may be taxed in the source state in accordance with the Convention. This view might rest either on the excess receipt over the paid-up capital being "income from shares"¹¹¹ or "income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is resident". The latter phrase seems in the references to "other corporate rights" to be referring to rights other than shares but it can be argued that this applies to a liquidation distribution because the right referred to is the right to receive distributions on liquidation.¹¹² The Commentary is therefore clear that so far as the source state is concerned it has taxed the distribution in accordance with Article 10, although it does not actually say that the residence state must accept this characterization. Even though the residence state of the shareholder may not consider that the liquidation results in a dividend, it is suggested that it must be implied that from the point of view of the residence state the source state has taxed in accordance with the provisions of Article 10, and accordingly the residence state must give credit for the source state tax.

Countries which, as residence states, tax liquidation distributions otherwise than as dividends (often as capital gains) include Canada (for liquidations of corporations not

resident in Canada), Germany (for small shareholdings owned by a company), Japan,¹¹³ the Netherlands (in the hands of a business shareholder), the United Kingdom and the United States. Of these, it is not clear whether the Netherlands¹¹⁴ would give any relief for dividend withholding tax imposed by the other state, and Germany would do so only by concession. Canada,¹¹⁵ Japan, the United Kingdom and the United States would give credit but have been eliminated in II. because they give credit by

103. See *supra* note 78, paras. 41, 42, 64.

104. See text *supra* at note 89. The reason may be that para. 64 provides for the parent/subsidiary relief to be given if the treaty provides for it, and the conclusion deals with the possibility that the treaty does not so provide.

105. Italy does not normally include such a provision in its treaties but there is an isolated example in Germany-Italy (1989) also referring to dividends within a particular paragraph of an article number, in such a way as to exclude income assimilated to dividends defined in another paragraph.

106. Belgium-Norway (1988). See also Belgian treaties with: China (1985), Hungary (1982), New Zealand (1981), Nigeria (1989), Pakistan (1980), Senegal (1987), Sri Lanka (1983), Sweden (1991), Turkey (1987), the United Kingdom (1987).

107. Official Commentary of tax treaties, chapter 9, para. 8.

108. As, for example, in Australia (to the extent that it represents income, whether derived before or after the liquidation, unless properly applied before the liquidation to replace a loss of paid-up capital), Belgium (but there would be no withholding tax), Canada, France, Germany, Italy, Japan, the Netherlands, Switzerland.

109. Under Article 13(4) of the Model. See the next paragraph for countries taxing liquidation distributions as a capital gain.

110. Article 10 Commentary para. 28: "Payments regarded as dividends may include...also other benefits in money or money's worth, such as...profits on a liquidation.... The reliefs provided in the Article apply so long as the State of which the paying company is a resident taxes such benefits as dividends." Article 13 Commentary para. 31: "The article [art.13] does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference [between the receipt and the par value] is covered by the definition of the term 'dividends' contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary relating thereto."

111. This view might be taken in the Netherlands. It would not be considered income in the United Kingdom.

112. The OECD Thin Capitalisation Report (see *supra* note 78) at para. 56 records two different interpretations of this phrase in relation to debt-claims, a narrower one which excluded any debt-claims because debt-claims have already been excluded by the words "(not being debt-claims)," and a wider one, which the majority preferred, including any financial relationship which constitutes a corporate right. The wider interpretation would presumably include liquidation distributions.

113. Liquidation distributions from a foreign corporation are taxed as ordinary income.

114. In the Netherlands with respect to (resident and non-resident) corporate shareholders a liquidation distribution is taxed on the amount by which the distribution exceeds the cost of the shares. To the extent this amount constitutes income from shares under Netherlands internal law (namely the excess of the distribution over paid-up share capital), it qualifies as a dividend for treaty purposes and the Netherlands could tax it as such. However, at the same time the amount can be classified for tax treaty purposes as a capital gain which, under Article 13(4), may not be taxed in the Netherlands. While in relation to liquidation distributions the question which of the two treaty articles has priority has not yet been decided by a Netherlands court, with regard to shareholder's income from the purchase by a company of its own shares the Hoge Raad has ruled in its decision of 24 May 1994, *BNB* 1994/219, that Article 10 has priority. If this decision is applied to liquidation distributions, the Netherlands would apply Article 10 over Article 13 and tax the gain to the extent that it is within the definition of dividend. It is reasonable that in the reverse situation (a resident business shareholder receiving a liquidation distribution from a company resident in the other state), the Netherlands would permit a credit for any dividend tax levied by the other state.

115. Except on distributions of exempt surplus from foreign affiliates which would be exempt in Canada, in which case no relief would be given for source state tax. Canadian liquidation distributions of foreign affiliates may be given deemed dividend treatment in the shareholder so elects.

reference to internal law which provides for credit in these circumstances.

c. Interest paid at an excessive rate

Article 11(6) provides that if interest is charged at an excessive rate by reason of a special relationship between the parties, the excess remains taxable under the laws of each state, due regard being had to the other provisions of the Convention. The same rule applies to excessive royalties under Article 12(4). It can be argued that taxation by the source state in any category must therefore be in accordance with the provisions of Article 11 (or 12) and so the residence state is obliged to give credit. This is the case in Switzerland as the internal law on credit¹¹⁶ makes an express reference to taxation under the internal law of the source state, provided it is in accordance with the treaty. Thus the reference in Article 11(6) to the taxation of the excess interest under the laws of each state has the practical effect that Switzerland will give a credit if the excess is categorized as dividend or interest by the source state. The Commentary, however, is not so definite as it provides that if the laws of each state require different articles to be applied it will be necessary to apply the mutual agreement procedure to resolve the difficulty.¹¹⁷ It is suggested that Article 11(6) is of limited assistance to the issue under consideration.

d. Payments by a partnership to a partner

Partnerships provide a good example of different characterization of income.¹¹⁸ The Commentary points out:

In many States, business profits of partnerships include, for tax purposes, all or some special remuneration paid by a partnership to its partners (such as rents, interest, royalties, remuneration for services), whilst in other States such payments are not dealt with as business profits (Article 7) but under other headings (in the above-mentioned examples: Articles 6, 11, 12, 14 or 15, respectively).¹¹⁹

The partnership state may allow a deduction for such payments to a partner, as in Belgium (sometimes), Canada (except for interest on capital), France, Italy, Switzerland (except for a *société simple*), the United Kingdom (except for interest on capital) and the United States (sometimes). If the partner's residence state regards the receipt as business profits,¹²⁰ the issue arises whether it will accept that credit should be given for withholding tax on, say, interest¹²¹ charged by the other state. If the partner's residence state is an exemption state it will consider that only the other state should have taxed the profits, while the partnership state may not have charged any tax or only a reduced withholding tax on, say, interest. This can lead to double exemption or only limited taxation in one state. This may arise in Switzerland and Germany, except that in a few German treaties¹²² Germany will give relief by credit, rather than exemption, in a case of different characterization. The United States Technical Explanation¹²³ of the United States-Germany treaty (1989) gives the payment of interest by a US partnership to a German partner as an example of a case where this provision will apply. The United States characterizes the payment as interest and no withholding tax is payable under the treaty; Germany characterizes it as business profits attributable to a permanent establishment in the United States which is exempt

from tax in Germany. In order to prevent the double exemption caused by Germany using its own characterization, the treaty allows Germany to apply a credit rather than exemption. Australia, Canada, Japan and the United Kingdom as the residence state of the partner would give credit under internal law in these circumstances, but Italy would not. No credit would be given in the Netherlands, although if it accepted that the interest was attributable to a permanent establishment, it would be exempt.

The second possible result is that the partnership's state will regard the payment as business profits, as in Australia, Canada (for interest on capital), France (for employment income), Germany, Japan,¹²⁴ the Netherlands,¹²⁵ Switzerland (for a *société simple*) and the United Kingdom (for interest on capital), while the partner's residence state regards it as the type of income which it is labelled, namely rent, interest, royalties or remuneration.¹²⁶ In this case the partnership state will tax the whole profits without a deduction for the payment and the partner's state will also tax the receipt in the category of income concerned. If the partner's residence state allows a credit only for the treaty rate of withholding tax on, say, interest, this will lead to double taxation. This problem can arise in Belgium and France as the partner's residence state. In Switzerland credit is provided by a combination of the treaty and internal law for dividends, interest and royalties, so there would be no credit in these circumstances. If Canada considered the receipt to be interest, for example when the interest was on a loan and not on the partner's capital, the credit would be limited to 15%. Italy would not give any credit because a non-resident partnership is not transparent. The United States would give full credit under internal law.

Because the Model does not provide any solution for partnerships, the Commentary does not say how these problems should be solved.

116. Federal Council Decree of 22 August 1967/7 December 1981, Article 1, para. 2.

117. Article 11 Commentary para. 36, Article 12 Commentary para. 26.

118. Reference should be made to the General and National Reports on International Tax Problems of Partnerships in 1995 *Cahiers de droit fiscal international* Vol LXXXa for more detail on this topic.

119. Article 1 Commentary para. 4.

120. This will not necessarily be the case in states other than those mentioned because the partner's residence state may follow the source state's characterization, leading to a result different from that which occurs when it is the source state.

121. Even if the partnership is not a treaty resident Article 11(5) of the Model would entitle it to charge a withholding tax on the interest.

122. See *infra* note 242.

123. 14 June 1990. For a case on this point under the earlier treaty, see *infra* note 245.

124. Since partnerships are transparent the income is business profits in the hands of a partner, probably attributable to a permanent establishment.

125. See Hoge Raad 23 March 1994, *BNB* 1994/192, discussed in Pieter M. Smit, "Taxation of a Belgian-Resident Limited Partner in a Netherlands Limited Partnership", 34 *European Taxation* 7 (1994) at 234, in relation to interest paid to a Belgian resident partner in a Netherlands closed limited partnership (CV), in which the court held that interest on the limited partner's capital, but not on its current account, was a share of profits.

126. This situation does not strictly arise under the heading of credit provision referring to specific types of income but is dealt with here for convenience.

2. The OECD Software Report

Credit in cases of differing characterization of income is also dealt with in the OECD Report on Software,¹²⁷ a topic which is likely to give rise to conflicting categorizations of income by treaty partners, whether as business profits, royalties, capital gains or income from independent personal services.¹²⁸ The Report contains the answers to a questionnaire¹²⁹ which includes the following question:

5.7. Where you have a treaty with the country of source which has exerted taxing rights having classified the income differently from your internal law, would you give double taxation relief and if so how and upon what measure of income?

Unlike the case of thin capitalization which depends on the defined term "dividends", payments for software could involve articles containing undefined categories of income. The Software Report is therefore more relevant to our consideration than the Thin Capitalisation Report. One assumes that the countries answered the above question on the basis of their own treaties, rather than the Model, but the answers may be of some assistance in interpreting the Model. The following countries replied that they did give relief in these circumstances but there were no answers to the second and third questions of how and upon what measure of income: the Netherlands,¹³⁰ Australia,¹³¹ Greece, Ireland, Germany,¹³² Austria, Japan, United Kingdom,¹³³ Italy, Denmark, Canada¹³⁴ and New Zealand.¹³⁵ On the other hand, the following countries said that they would give relief only by mutual agreement (which implies that without the mutual agreement the treaty would not give relief, and also that there is no unilateral relief): Sweden,¹³⁶ Switzerland,¹³⁷ Norway,¹³⁸ France, Luxembourg and Belgium.¹³⁹ If the answers by the second category of countries are correct, these countries do not therefore give relief where their characterization differs from that of the source state. The United States,¹⁴⁰ Spain and Portugal did not answer the question.

The Report seems to describe what states do in practice without taking a position whether such practice is in accordance with the Model if the wording of the Model is used in the relief from double taxation article. Not all the answers seem to be correct. According to our understanding of the Netherlands answer,¹⁴¹ it would be more accurate to put the Netherlands into the other category and say that it does not give relief in cases of differing characterization. The German answer does not seem correct in the light of the provision included in several German treaties¹⁴² which would not be necessary if Germany gave relief, and of the case¹⁴³ mentioned below, although it is understood that Germany sometimes gives relief by concession.

3. Views of other authors

Many authors, for example Professor Vogel,¹⁴⁴ take the view that Article 3(2) creates a conflict between the source and residence states in cases of different characterization of income. In their 1993 IFA General Report on Interpretation of Double Taxation Conventions, he and Dr Prokisch conclude:

...the General Reporters think that the residence state, when exempting income from taxation or granting a credit, may and will verify that the source state applied the convention in a – in its eyes – correct way; should the residence state

come to a different conclusion, it will deny the tax exemption or allowance. Therefore the residence state too, applies the distributive rules in these cases.¹⁴⁵

127. See *supra* note 7, at 81, 96-98, para. 32 at 72 and para. 52(e), at 77.

128. See *supra* note 7, para. 34. A number of treaties clarify the position by including software specifically in the definition of royalties. These include Canada-Netherlands (1986, 1993 protocol), Germany-Bulgaria (1987), Germany-USSR (1981), Unites States-France (1994), Unites States-Canada (1980, 1994 protocol), Japan-Israel (1993), Japan-Singapore (1994).

129. See Appendix 1 to the Report and Appendix 2 for the answers.

130. "Yes, if in accordance with treaty." It is understood that this was intended to mean that relief would be given only if the other state taxed the income in the same treaty category as the Netherlands. The reference to internal law in the question may have obscured the fact that the question really relates to different treaty characterization because in general the Netherlands only gives credit under treaty and for income from listed developing countries (there are very few non-treaty countries which are not listed as developing countries).

131. "Yes, if foreign source", which seems to be a reference to internal law since Australian treaties deal with source.

132. See the comment in the next paragraph of the text about whether the answer is correct.

133. "In accordance with treaty", hopefully having the meaning suggested *supra* in note 130.

134. "Yes, under domestic rules." Since domestic rules are applied by treaty this means that Canada does give relief under treaties as well. The question does not normally arise because Canadian treaties follow internal law (ITA s.212(1)(d)(vi)) in exempting from withholding tax in both states royalties in respect of copyright in respect of the production or reproduction of any literary work. Withholding tax can, however, arise on payments for shrink-wrapped software which are regarded as payments for the use of the software, rather than for the production or reproduction of it. The 1994 Protocol to the Unites States-Canada treaty eliminates from withholding tax payments for the use of computer software. It should be noted that relief may be limited if Canada categorizes the receipt as income from a business carried on by the Canadian resident in the other country (in which case the foreign tax will be classified as business income tax and the credit is not limited to 15% but is limited by the percentage of Canadian tax on net profits of the business). If Canada does not treat the royalty as part of business profits, the foreign tax will be a non-business income tax with the credit limited to 15%. This characterization will be made entirely on the basis of Canadian tax law.

135. This list includes the common law countries and Japan which we have eliminated in II. as giving treaty credit by reference to their internal law which provides for credit in cases of differing characterization. These answers therefore reflect their internal law. In addition to the countries represented, Denmark uses credit in cases of income which may be taxed in the other state, and exemption in cases of income which is taxable only in the other state, but does not refer to credit rules of its internal law in its treaties; Greece uses the credit method but does not refer to internal law credit rules in its treaties; New Zealand uses the credit method and refers to internal law in its treaties in a similar way to Australia.

136. "Yes by mutual agreement."

137. "No, but mutual agreement tried." Switzerland would give credit for the reasons given in II, but not exemption.

138. The last four countries all said "mutual agreement".

139. In Belgium where modern treaties refer to internal law for credit rules (see *supra* note 39) and the income is a royalty under internal law, credit would be given even if the other state taxed it on a different basis, but no credit would be given if the other state categorized the payment as a royalty but Belgium did not. It is not clear why application of the mutual agreement procedure (see *supra* note 138) is necessary, unless it is in an attempt to convince the other state that it has mischaracterized the income.

140. The answer in the United States should have been that relief would be given under internal law which is applied by the treaty, see II.

141. See *supra* note 130.

142. See text *infra* at note 242.

143. See text *infra* at note 245.

144. *Klaus Vogel on Double Taxation Conventions*, (Deventer: Kluwer, 1991), Article 3, mn 60 (and 1994 Supplement Article 3, mn 57, 58), and Introduction, mn 97, 98.

145. *Cahiers de droit fiscal international*, Vol. LXXVIIIa, 1993, at 79 in the English version.

This view was supported by the National Reporters from New Zealand,¹⁴⁶ the Netherlands¹⁴⁷ and Norway,¹⁴⁸ but not those from Canada¹⁴⁹ and the United Kingdom,¹⁵⁰ whose authors are represented in this article. Edwardes-Ker takes the same view as Vogel and Prokisch and gives the following six reasons against the view that Article 3(2) of the Model requires the residence state to follow the source state's characterization.¹⁵¹ First, the loss of sovereignty by the residence state; secondly, it is difficult to derive this result from the language of Article 3(2); thirdly, under the government service article the residence state has exclusive taxation and must therefore use its own definitions; fourthly, it is said to conflict with the original intentions of the draughtsmen of the Model; fifthly, even if the source state's characterization is erroneous the residence state has to accept this as the only way to avoid double taxation; sixthly, the approach assumes too readily that the context does not otherwise require. We shall comment on these points below but anticipate the next section by saying that Article 3(2) may not be applicable to the issue under consideration. The point should be made here that the third and fifth reasons are based on misunderstandings. In relation to the third, the point is not that in all cases the source state's characterization applies (the government service article being a clear exception), but that in giving credit or exemption the residence state should accept the source state's characterization, even when the residence state would have categorized the income differently. The fifth reason seems odd; the mutual agreement article is designed to deal with the situation that the residence state considers that the source state has incorrectly applied the treaty (from the source state's point of view) and, as has already been mentioned,¹⁵² there is no question of the residence state being bound by an incorrect application of the treaty by the source state.

The American Law Institute Report¹⁵³ does not take a position about whether Article 3(2) requires the residence state to follow the source state's characterization, but recommends that this should be the treaty rule where the conflict cannot be resolved by mutual agreement.

So far as we are aware, other authors have not made any distinction between internal law and treaty relief provisions and between Article 23A(1) of the Model dealing with named categories of income, and the remaining part of Article 23A dealing with exemption as well as Article 23B dealing with unnamed categories of income.

4. Discussion of the interpretation of characterization of income by article number

a. *The relevance of Article 3(2)*

When considering a reference in the credit provision to another article of the treaty dealing with an undefined category of income, the question we have to consider is whether the residence state should use its own meaning of the undefined category of income in order to determine whether it is an "item of income which, in accordance with the provisions of article y, may be taxed in the other Contracting State."¹⁵⁴ At first sight, the residence state is required to use its own meaning of the category of income by virtue of Article 3(2) of the OECD Model.¹⁵⁵

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 which 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.

The initial question is what is the term to which Article 3(2) applies? The expression "items of income which, in accordance with the provisions of article y, may be taxed in the other Contracting State" is a composite expression meaning income which may be taxed as type y income by the source state, whereas "income of type z," (z being the type of income dealt with in article y) is clearly a term. If there were two separate questions: "is it type z income?", and "may it be taxed in the source state in accordance with the Convention?" the residence state might apply Article 3(2) and look to its own law to answer the first. But there is only one question, and that is aimed at the source state. The source state applies Article 3(2), or at least reads the treaty in the light of its internal tax law definition to see whether it is prevented from taxing the income,¹⁵⁶ or if not prevented, has a reduced right, or limited right, to tax the income. There is no reason why the residence state must do the same and apply Article 3(2) at all because there is no undefined term requiring definition. On this analysis, Vogel's interpretation and Edwardes-Ker's six reasons in favour of it¹⁵⁷ are not applicable. We shall therefore proceed initially on the basis that Article 3(2) does not apply in the residence state.

b. *The ordinary meaning of the words in their context*

Article 31 of the Vienna Convention on the Law of Treaties provides that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given

146. P.488. Credit is given in New Zealand in cases of different characterization but only where the income does not have a New Zealand source.

147. P.459.

148. P.506.

149. P.281.

150. P.608.

151. *Tax Treaty Interpretation*, In-Depth Publishing, 1994, para. 8.20. These arguments are directed at the Canadian and UK IFA national reports (see *supra* note 145) which were based on Article 3(2), rather than the argument put forward here.

152. See text *supra* at note 17. This point is made in the Canadian National Report in the IFA *Cahiers* (see *supra* note 145), at 282.

153. Federal Income Tax Project, *International Aspects of United States Income Taxation II*, (Philadelphia, 1992), at 62, 237.

154. Article 23A(2) of the Model.

155. This is quoted as amended by the September 1995 update.

156. John Avery Jones has argued that in the latter case the source state does not apply the treaty, see "Qualification Conflicts: the Meaning of Application in Article 3(2) of the OECD Model", *Festschrift für Karl Beusch*, (Berlin: Walter de Gruyter, 1993), at 43. This argument is not pursued here.

157. See text *supra* following note 151

to the terms of the treaty in their context¹⁵⁸ and in the light of its object and purpose". The ordinary meaning of the terms indicates that the question whether there are "items of income which, in accordance with the provisions of article y, may be taxed in the other Contracting State" must be answered only from the point of view of the source state. The starting point is to determine the meaning of income of type z as determined by the source state when it imposes tax on the income for which we are trying to determine whether the residence state should give credit. If the source state applies its own internal tax law meaning of income within article y, from its point of view it will have taxed that income in accordance with the provisions of article y, assuming (since we are considering credit) that article y does not prevent the source state from taxing income of that category. Since article y has to be considered by both states – first, by the source state as it has to decide whether it is prevented from taxing or required to reduce its tax, and, secondly, by the residence state as it has to decide whether to give credit – it would be odd if the correct interpretation of this phrase caused a conflict between the two states. On that basis it may be asked whether the residence state needs to consider whether under its law a similar payment would be within article y. If the residence state accepts this approach, it is not saying that, in the residence state, income of article y has the meaning which it has in the source state; it is merely saying that the residence state is accepting that the source state, in using its own meaning, has taxed in accordance with the treaty. It has been argued¹⁵⁹ that this proposition accepts that the source state can increase its taxing rights at the expense of the residence state, and, even though that argument applies equally to both states, a capital exporting state is likely to lose more than it gains by an expansion of taxing rights. This argument seems to us to raise a different issue, that of the extent to which Article 3(2) is ambulatory,¹⁶⁰ rather than the issue under consideration.

c. Object and purpose

There is a strong presumption that, as the object and purpose¹⁶¹ of the treaty is to prevent double taxation,¹⁶² the residence state should not use its own definitions of those categories as this could lead to double taxation, or to no taxation, neither of which is an object or purpose of the treaty. Where the treaty in question is based on the Model this argument appears to be stronger because this must be an important purpose of the Model.¹⁶³ There seems no reason why this should not be equally true where a treaty refers to articles not containing defined categories of income although the Model uses the method of specifying a category of income by article number only in relation to Articles 10 and 11, both of which contain defined categories of income.

d. Supplementary means of interpretation

Under Article 32 of the Vienna Convention on the Law of Treaties

recourse may be had to supplementary means of interpretation...in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the

meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.

Although the issue of undefined categories of income being referred to by specific article number does not arise under the Model, some assistance can be gained from the Commentary's treatment of defined terms, dividends and interest. Read in the light of its origins in the Thin Capitalisation Report, the Commentary states that in thin capitalization cases credit is to be given in spite of different characterization by the two states in relation to the defined term "dividends", the definition of which refers, at least in part, to the laws of the source state. The Commentary states that the source state correctly taxes liquidation distributions as dividends when its law includes them as dividends but does not expressly deal with the consequences in the residence state, although it seems to be implied that the residence state must give credit even though it does not regard the liquidation distribution as a dividend under its law.

There is no statement directly in point in the Commentary relating to credit for undefined categories of income. The Software Report, which not only deals with articles containing definitions of the category of income, but also other articles where the category is undefined, is more relevant to our consideration. The Report provides evidence that some countries¹⁶⁴ in practice interpret their treaties in a way that a difference in characterization may lead to double taxation. However, the amendments to the Commentary made by the Software Report do not deal with credit or exemption. The Report can still, therefore, be used as supplementary means of interpretation but less weight might be given to it.

158. Context is defined in Article 31(2) of the Vienna Convention on the Law of Treaties to mean the text, the preamble and annexes and also any agreement relating to the treaty made between all the parties in connection with the conclusion of the treaty, and any instrument made by one of the parties in connection with the conclusion of the treaty and accepted by the other party as an instrument related to the treaty. In addition the following are taken into account: subsequent agreements between the parties regarding the interpretation of the treaty or the application of its provisions, and any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation, and any relevant rules of international law.

159. For example, Edwardes-Ker's first argument in the text *supra* following note 151.

160. See Article 3 Commentary paras. 11-13.

161. Note the reference to intention of the Contracting States as part of the context in Article 3 Commentary para. 12.

162. Although the Model does not refer to the avoidance of double taxation in the title of the Model it adds a footnote to the title that states wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion. The Recommendation of the OECD Council of 31 March 1994 recites as a reason for treaties that: "Considering the need to remove the obstacles that international juridical double taxation presents to the free movement of goods, services, capital, and persons between the Member countries of the OECD by the conclusion of conventions between them for that purpose."

163. See Article 1 Commentary para. 7.

164. Of the countries represented here, these are Belgium, France and Switzerland, see text *supra* around note 136. We would also add the Netherlands for the reason given *supra* in note 130. The amount of credit in Canada could also be limited in a case of different characterisation for the reason given *supra* in note 134.

e. *Alternative interpretation if Article 3(2) applies*

Suppose, contrary to the argument above, that the residence state does apply Article 3(2) and uses its own internal law to determine whether the income is of type z. We have to ask whether the context requires that it should not do so. Context has a wider meaning here than the definition in the Vienna Convention on the Law of Treaties considered above. The meaning of a term in the other state is given in the Commentary as an example of the context for the purpose of Article 3(2).¹⁶⁵ We suggest, therefore, that the context does otherwise require, principally on the basis that, taking into account the meaning of the term in the source state, the context of the relief of double taxation article requires that relief should be given in cases of differing characterization.¹⁶⁶ The argument for the context requiring that the residence state's definition should not be used is stronger here than in IV.C., concerning a category of income specified by type in the credit article, where the only question the residence state has to ask is whether the income is of that type.

f. *Conclusion*

If the question whether something is income which, in accordance with the provisions of article y, may be taxed in the other Contracting State is not one which requires the residence state to apply Article 3(2), it is reasonably clear that on the ordinary meaning of the words of the treaty the residence state should not apply its own meaning of income of type z but rather should accept the source state's decision for the sole purpose of giving credit so long as the source state's characterization is otherwise in accordance with the treaty, for example that its thin capitalization rule conforms to the arm's length principle. The Commentary, which might be used as a supplementary means of interpretation, contains no clear statement on the topic as it does not arise under the Model, but there are implications to the contrary in the Software Report.

If the question is one to which Article 3(2) applies, it is suggested that there is a case for the context requiring that the residence state's meaning should not be used.

5. Country practice

The arguments put forward above are not accepted in France and the Netherlands, these being the only countries represented not already eliminated in II. and which refer to undefined categories of income by article number.¹⁶⁷ We now look at how these countries give relief in cases of differing characterization of income. As we have seen, France applies the principle of autonomy of interpretation and does give credit for dividend withholding tax on interest recharacterized by the other state as a dividend in accordance with thin capitalization provisions. According to the Software Report,¹⁶⁸ France interprets its treaties as not requiring credit to be given in circumstances where its internal law definitions, if applied, would indicate that the source state should not have taxed. In relation to payments by a partnership to a partner of interest, France would only give credit for the appropriate rate of withholding tax even in cases where the partnership's state did not give a deduction for the payment and taxed it as business profits.

In the Netherlands no case¹⁶⁹ has been found in which the treaty classification of the income by the other state played a role.¹⁷⁰ Although it is stated in the Software Report that the Netherlands would give credit in case of differing characterization of software by the other state, the answer may not have been intended to mean this.¹⁷¹ As we have seen, it is possible that the Netherlands might give credit for dividend withholding tax on a liquidation distribution where the other country classified it as a dividend.¹⁷²

B. Category of income specified by article number and descriptive type

A second possibility of determining the type of income qualifying for credit in a state which otherwise uses the exemption method is to refer to both the descriptive type of income and the article number. This is used fairly frequently. We can give as examples the following extracts from Belgian, German, Italian and Swiss treaties.¹⁷³

Belgium

where a resident of Belgium derives from sources within the United Kingdom:

- (i) *dividends dealt with in accordance with paragraph 2 or paragraph 3 of Article 10 of this Convention*, not exempted from Belgian tax in accordance with sub-paragraph (c) of this paragraph,
- (ii) *interest dealt with in accordance with paragraph 2 or paragraph 6 of Article 11 of this Convention*, and
- (iii) *royalties dealt with in accordance with paragraph 4 of Article 12 of this Convention*,

the fixed proportion in respect of foreign tax for which provision is made under Belgian law shall, under the conditions and at the rate provided for by such law, be allowed as a credit against Belgian tax relating to such income.¹⁷⁴

Germany

2. Where a resident of the Federal Republic of Germany derives income or owns capital which, in accordance with the provisions of this Agreement, may be taxed in Canada, double taxation shall be avoided as follows:

...(b) There shall be allowed as a credit against German tax on income, subject to the provisions of German tax law regarding credit for foreign tax, the Canadian tax

165. Article 3 Commentary para 12.

166. This is in agreement with Edwardes-Ker's sixth argument, see text *supra* following note 151.

167. For examples of their treaty wording, see IV.A.

168. See *supra* note 7, Appendix 2.

169. This covers the period 1965 to 1995.

170. For examples of cases in the Netherlands which applied the Netherlands characterization of the income in order to give relief, see the following decisions of the Hoge Raad: BNB 80/259* and 91/312* on Indonesian pensions, and BNB 92/245* on whether a model had a fixed base in France or Germany.

171. See *supra* note 130.

172. See *supra* note 114.

173. We have italicized the relevant passages.

174. Belgium-United Kingdom (1987). This method of referring to a category of income is used in all modern Belgian treaties.

(including taxes on income paid to any political subdivision or local authority in Canada) paid in accordance with the provisions of this Agreement referred to below on the following items of income:

- (i) *dividends within the meaning of Article 10* which are not dealt with in sub-paragraph (a) above [exemption];
- (ii) *interest within the meaning of Article 11 and royalties within the meaning of Article 12;*
- (iii) *gains from the alienation of property taxable in Canada by reason only of Article 13, paragraphs 4 and 6(a);*
- (iv) *income within the meaning of Article 15, paragraph 3 and Articles 16 and 17;*
- (v) *pensions and annuities within the meaning of Article 18, paragraphs 1 and 2;*
- (vi) *income taxable in Canada by reason only of Article 21, paragraph 1.*¹⁷⁵

Italy

...where the tax on business profits, dividends, interest or royalties arising in a Contracting State is exempted or reduced for a limited period of time in accordance with the laws and regulations of that State, such tax which has been exempted or reduced shall be deemed to have been paid at a full amount in the case of business profits and at an amount not exceeding:

- (a) 10% of the gross amount of the *dividends and interest referred to under Articles 10 and 11;*
- (b) 15% of the gross amount of the *royalties referred to under Article 12.*¹⁷⁶

Switzerland

Where a resident of Switzerland derives *dividends, interest or royalties which, in accordance with the provisions of Articles 10, 11 and 12,* may be taxed in Australia, Switzerland shall allow, upon request, relief to that person. The relief may consist of:

- (a) a deduction from the Swiss tax on the income of that person of an amount equal to the tax levied in Australia in accordance with the provisions of Articles 10, 11 and 12; such deduction shall not, however, exceed that part of the Swiss tax, as computed before the deduction is given, which is attributable to the income which may be taxed in Australia...¹⁷⁷

In all these examples the category of income for which credit is given is given both by descriptive type and article number except in paragraph (b) of the German example for cases (iv) and (vi) where the reference is to an article number only.¹⁷⁸ In addition to the defined items of dividends, interest and royalties applicable in the other countries, in the German example two other categories are included in this way for relief under the credit method.

This method is really the same as the previous one of referring to the article number with the addition of the description of the type of income dealt with in that article. The Thin Capitalisation Report¹⁷⁹ treats as equivalent: "items of income dealt with in Article 10" and "income defined as

dividends in Article 10". It seems reasonably clear that this formula is no different in effect from the reference to the type of income by article number alone, and the conclusion reached in IV.A. is equally applicable here.

So far as countries using this method are concerned, we have eliminated Belgium and Switzerland from the discussion in II. in view of the reference to internal law which requires characterization of dividends, interest and royalties by Belgium according to Belgian (as residence state's) law, and by Switzerland according to the source state's law, so long as it is otherwise in accordance with the treaty. In most other cases states do not accept that they need to give relief if their characterization differs from the source state's. In spite of Germany's answer to the question in the Software Report, Germany seems unlikely to give relief, except by concession, where the other country categorized the income differently. It also seems that if Germany, as residence state of a corporate shareholder with a small shareholding, regards a liquidation distribution as a capital gain but if the source state taxes it as a dividend, credit will be given only by concession. This aspect is discussed further in V.¹⁸⁰ Nor does Germany give relief for a payment by a partnership to a partner where the other state considers the payment to be, for example, interest, while Germany considers it to be business profits which it maintains only the other state should tax.

C. Category of income specified by descriptive type alone

1. Articles based on Article 23a(2) of the Model

The third way in which a treaty article may provide for relief for a category of income is that, instead of referring to the article number, the treaty might name the category of income, such as dividends. Articles in the form of Article 23A(2) of the Model providing credit for categories of income specified by descriptive type rather than article number are not common. Among the countries represented, only Germany sometimes uses this method, usually only in relation to dividends, interest and royalties,¹⁸¹

175. Germany-Canada (1981).

176. Italy-China (1986). This is a tax sparing provision rather than part of the normal credit method which in Italy applies to all categories of income and is dealt with in V. And see also Italian treaties with: Korea (1989), Egypt (1979) not including royalties, India (1981), Malaysia (1984), Malta (1981), Pakistan (1978) not including royalties, Sri Lanka (1984).

177. Switzerland-Australia (1980).

178. The reference in case (vi) to income taxable by reason only of Article 21, para. 1 is a reference to the Other Income article, and therefore would not be expected to include a reference to a descriptive type of income.

179. See *supra* note 78, para. 64.

180. See text *infra* at notes 242 and 245.

181. Reference is made to defined categories of dividends, interest and royalties without mentioning the article number, in Bangladesh (1990), China (1985) and Zimbabwe (1988), and to those and other categories of income in Indonesia (1990). In many German treaties relief for tax on dividends, with exemption for dividends from direct holdings and credit in other cases, is provided for without mentioning an article number, as in Bulgaria (1987), Czechoslovakia (1980), Egypt (1987), Kuwait (1987), the Philippines (1983). In a few cases the exemption for dividends on direct investments is in terms of dividends (undefined) while the credit for other dividends refers to a treaty article number, e.g. Canada (1981), Norway (1991), Portugal (1980), Turkey (1985), the United States (1989).

although normally German treaties refer to categories of income by article number or both by descriptive type and article number.¹⁸² An example providing for credit for a wider list of categories of income specified by type is found in a recent German treaty.¹⁸³

2. In the case of a resident of the Federal Republic of Germany, double taxation shall be avoided as follows:

(a) Items of income arising in the United Mexican States and elements of capital situated in the United Mexican States which, according to this Convention, may be taxed therein, shall be exempt from German tax, unless the deduction provided for in subparagraph (b) applies...

In the case of *dividends*, the exemption shall apply only to such dividends as are paid to a company (excluding partnerships) which is a resident of the Federal Republic of Germany by a company which is a resident of the United Mexican States at least 10% of the capital of which is owned directly by the German company....

(b) Subject to the provisions of the German tax laws regarding tax credit for foreign taxes, there shall be allowed as a credit against German income tax, corporate tax and capital tax payable in respect of the following items of income arising in the United Mexican States and capital situated therein, the Mexican tax paid under the Mexican laws and in accordance with this Convention on:

(aa) *dividends* not dealt with in subparagraph (a);

(bb) *interest*;

(cc) *royalties*;

(dd) *directors' fees*;

(ee) *income derived by artistes and sportsmen*;

(ff) *immovable property and income therefrom*. The foregoing sentence shall not apply if the immovable property is effectively owned by a permanent establishment of the kind referred to in Article 7 and situated in the United Mexican States, or by a fixed base in the sense of Article 14 and situated in the United Mexican States, unless the provisions of subparagraph (a) [exemption] does not apply, under the provisions of subparagraph (d), to profits of the permanent establishment;

(gg) alienation of shares and participations referred to in paragraph 4 of Article 13; and

(hh) income referred to in paragraph 2 of Article 21.

In the last paragraph of paragraph (a) dealing with exemption, dividends are referred to, and in the credit provision in paragraph (b) the first six categories are descriptive types of income, and the last two are identified respectively by article number and type and, in relation to "other income," by article number only. It should be noted that, as in IV.A., taxation must be in accordance with the provisions of the convention.

2. Other provisions referring to income by descriptive type

Specific references to certain categories of income, such as to dividends in treaty provisions granting credit for underlying tax on, or exemption for, dividends from subsidiaries, are found in the credit or exemption articles of some treaties, such as the following examples. The main difference between these examples and the credit provisions in the German treaty above is that the treaty does not make the credit or exemption conditional on whether tax has been paid in accordance with the provisions of the Convention. The following examples include both income

qualifying for credit and exemption being specified by type.

Australia

Where a company which is a resident of Spain and is not a resident of Australia for the purposes of Australian tax pays a *dividend* to a company which is a resident of Australia and which controls directly or indirectly not less than 10% of the voting power of the first-mentioned company, the credit referred to in paragraph 1 shall include the Spanish tax paid by that first-mentioned company in respect of that portion of its profits out of which the dividend is paid.¹⁸⁴

Belgium

Where a company which is a resident of Belgium owns shares in a company which is a resident of the United Kingdom, the *dividends* paid thereon to the former company which have not been dealt with in accordance with paragraph 5 of article 10 of this Convention¹⁸⁵ shall be exempted in Belgium from the tax referred to in paragraph 1(b)(ii) of Article 2 of this Convention, to the extent that exemption would have been accorded if the two companies had been residents of Belgium.¹⁸⁶

Canada

Subject to the existing provisions of the law of Canada regarding the determination of the exempt surplus of a foreign affiliate and to any subsequent modification of those provisions – which shall not affect the general principle hereof – for the purpose of computing Canadian tax, a company resident in Canada shall be allowed to deduct in computing its taxable income any *dividend* received by it out of the exempt surplus of a foreign affiliate resident in the United Kingdom.¹⁸⁷

Germany

The foregoing provisions of this paragraph [exemption] shall also apply to *dividends* on shares which are paid to a company which is a resident of the Federal Republic of Germany by a company which is a resident of Canada if at least 25% of the capital of the Canadian company is held directly by the Germany company.¹⁸⁸

Italy

Where a company which is a resident of Italy holds at least 25% of the capital of a company which is a resident of Brazil, Italy shall exempt from tax the *dividends* received by the company which is a resident

182. See IV.B.

183. Germany–Mexico (1993). A similar example is found in Germany–Indonesia (1990).

184. Australia–Spain (1992).

185. Corresponding to Article 10(4) of the Model.

186. Belgium–United Kingdom (1987). Normally in its treaties Belgium requires that the dividends should be taxable in the source state under Article 10 before exempting them, see *supra* note 106.

187. Canada–United Kingdom (1978).

188. Germany–Canada (1981). See also the treaty with Mexico quoted above, Bangladesh (1990), Bulgaria (1987), China (1985), Czechoslovakia (1980), Egypt (1987), Indonesia (1990), Kuwait (1987), Norway (1991), the Philippines (1983), Portugal (1980), Turkey (1985), the United States (1989), Zimbabwe (1988). Unusually there is a reference to the article number in the equivalent provisions in the treaties with Ecuador (1982) and Italy (1989).

ent of Italy from the company which is a resident of Brazil.¹⁸⁹

Japan

Where the income derived from Singapore is a *dividend* paid by a company which is a resident of Singapore to a company which is a resident of Japan and which owns not less than 25% either of the voting shares of the company paying the dividend, or of the total shares issued by that company, the credit shall take into account the Singapore tax payable by the company paying the dividend in respect of its income.¹⁹⁰

Switzerland

A company which is a resident of Switzerland and which derives *dividends* from a company which is a resident of Australia shall be entitled, for the purposes of Swiss tax with respect to such dividends, to the same relief which would be granted if the company paying the dividends were a resident of Switzerland.¹⁹¹

United Kingdom

Where such income is a *dividend* paid by a company which is a resident of [] to a company which is a resident of the United Kingdom and which controls directly or indirectly not less than one-tenth of the voting power in the former company, the credit shall take into account (in addition to any [] tax payable in respect of the dividend) the [] tax payable by that former company in respect of its profits.

United States

...the United States shall allow to a citizen or a resident of the United States as a credit against the United States income tax:...

(ii) in the case of a United States company owning at least 10% of the voting power of a company that is a resident of France and from which the United States company receives *dividends*, the French income tax paid by or on behalf of the distributing corporation with respect to the profits out of which the dividends are paid.¹⁹²

Dividends are defined in the Model only for the purpose of Article 10¹⁹³ and, unlike examples cited in IV.A. and IV.B., there is no reference here to Article 10. Whether the definitions contained in a different article apply is discussed in the Thin Capitalisation Report¹⁹⁴ in which it is noted that in some countries¹⁹⁵ these definitions, being the closest relevant context, might be preferred to other definitions; whereas other countries presumably apply their own internal law definitions under Article 3(2) on the grounds that the term is not defined for the purpose of the double taxation relief article. The internal law meaning of dividend in the residence state is applied in the examples above,¹⁹⁶ so that relief is not given for source state tax on interest categorized by the source state as a dividend under thin capitalization provisions, or in other cases where the distribution is not a dividend from the perspective of the residence state.¹⁹⁷

Another example of the characterization of income by type can be found in some tax sparing provisions, as in these examples:

Italy

For the purposes of paragraphs 1 and 2 of this Article, where tax on *business profits, dividends and interest* arising in a Contracting State is exempted or reduced for a limited period of time to promote economic development of that State, such tax which has been exempted or reduced shall be deemed to have been paid at an amount not exceeding 25%.¹⁹⁸

Canada

For the purpose of paragraph 1(a) [credit to be given by Canada], tax payable in Bangladesh by a resident of Canada

(a) in respect of *income or profits attributable to a trade or business* carried on by it in Bangladesh, or

(b) in respect of *dividends or interest* received by it from a resident of Bangladesh,

shall be deemed to include any amount which would have been payable as Bangladesh tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under [the legislation set out].¹⁹⁹

It is believed that in Canada under Article 3(2) of the Model the type of income in these examples is to be interpreted in accordance with the residence state's law because that is the state applying the treaty in giving tax sparing relief, rather than in accordance with the definitions contained in articles dealing with the type of income concerned. In Italy, it is possible that the contrary conclu-

189. Italy-Brazil (1978).

190. Japan-Singapore (1994). A similar provision is found in 21 other Japanese treaties.

191. Switzerland-Australia (1980).

192. United States-France (1994). Credit is given by reference to the provisions of US law, as considered in II.

193. The same is true of the definitions of interest and royalties.

194. See *supra* note 78, para. 51.

195. Not ones represented by the authors of this article unless it relates to the common law principle that statutes *in pari materia* should be read together. In Canada this principle has been codified in the Interpretation Act s.15(2): "where an enactment contains an interpretation section or provision, it shall be read and construed. (b) as being applicable to all other enactments relating to the same subject matter unless a contrary intention appears". A similar argument could be made for applying a definition applicable to one article of a treaty to another.

196. This may look to the other state's corporate law to determine whether the payment is a dividend, see, for example in the United Kingdom, *Rae v Lazard Investment Co.* 41 TC 1 and *Courtauld Investments Ltd. v Fleming* 44 TC 111.

197. Such as, in the United Kingdom the transfer of an asset at an undervalue to a shareholder, which is a distribution not a dividend. Interest on an equity note (perpetual debt instrument) issued to an associated company is another example. Formerly a deduction could be obtained in the United Kingdom for interest on these and the United States characterized the receipt as a dividend and did not tax it. The law was changed in the United Kingdom to make the interest into a distribution, see TA 1988, s.209(2)(e)(vii). In the reverse case of such debt issued by a US company, the situation remains that the United States treat the payment as a dividend if the payment was made out of earnings and profits, and the United Kingdom treats the receipt as interest, without giving any relief for the underlying US tax, because the receipt is not a dividend from the UK point of view.

198. Italy-Pakistan (1984), see also treaties with India (1981), Ivory Coast (1982).

199. Bangladesh (1982). See also Barbados (1980), Cameroon (1982), Cyprus (1984), Egypt (1983), Guyana (1985), Ivory Coast (1983), Kenya (1983), Malta (1986) (not business profits), Mexico (1991) (dividends from companies whose earnings are primarily from business in Mexico deemed to have suffered 15%), Tunisia (1982), Zambia (1984).

sion might be reached. Credit would certainly be given in Italy if the source state levied tax, and so it would be odd if it did not do so because the source state decided not to levy tax in order to promote economic development. This argument is much stronger in the cases in which the treaty refers to a reduction in the source state tax in accordance with the source state's law because that is not a matter which the residence state can determine.²⁰⁰ Other countries, including Australia,²⁰¹ Belgium,²⁰² France,²⁰³ Germany,²⁰⁴ Italy in some other treaties,²⁰⁵ Japan,²⁰⁶ the Netherlands²⁰⁷ and Switzerland²⁰⁸ normally avoid this issue by referring to treaty articles by number when giving tax sparing relief.²⁰⁹

3. OECD reports

a. *The Thin Capitalisation Report*

This method of referring to the type of income qualifying for credit is dealt with in the Thin Capitalisation Report in the passage already quoted:²¹⁰

If the text of the relevant Article [dealing with credit] simply gave relief in respect of 'dividends' without referring to Article 10, and if there was no generally applicable definition of dividends elsewhere in the relevant bilateral treaty, the meaning of 'dividends' for this purpose would depend on the domestic law of the country of residence of the lender,²¹¹ which would not necessarily accept any extended definition of 'dividends' provided by the thin capitalization rules of the country of the paying company.

This is followed by the three cases²¹² in which it is stated that relief might be given in certain cases of thin capitalization by virtue of the context. First, the treatment by the source state is in accordance with Article 9, in which case the residence state is obliged to make a corresponding adjustment under Article 9(2) which would include giving relief as a dividend, and the same for excessive interest treated as a dividend under Article 11(6). Secondly, the residence state would have applied similar thin capitalization provisions if it had been the source state. Thirdly, the residence state agrees that it is proper to treat the interest as a dividend. The Report says that the circumstances are limited in which the context otherwise requires that the residence state's definition of dividends should not be used by virtue of Article 3(2). In particular, there is no suggestion that the residence state should generally respect the source state's characterization. It is not clear whether the Report has in mind examples such as the German treaty in IV.C.1. above or the other examples in IV.C.2. above, although the latter seems more likely as such examples are much more common.²¹³ There is also no discussion of the source state's taxation being in accordance with the Convention, the presence of which would indicate that the residence state should accept the source state's characterization. Although it would be unlikely that dividends would not be defined elsewhere in the treaty in the way suggested in the Report, it should be noted that the definition of dividends which in the Model refers to the source state's characterization applies only for the purposes of the dividend article. In our view, the same reasoning may apply to undefined terms. It therefore seems that the OECD regards the cases where the context otherwise requires as limited to the type of cases listed in the Report

(which include all thin capitalization cases where the recharacterization is in accordance with Article 9), so that double taxation may arise in other cases because the residence state applies its own definitions which are contrary to the source state's. This is broadly accepted by countries represented by the authors in interpreting the provisions in IV.C.2. above.

b. *The 183-Day Rule Report*

An analogous point where an undefined term has a different meaning in each state, although it should be emphasized that it does not relate to credit, arises in the OECD Report on the 183-day rule²¹⁴ in Article 15 of the Model. In it, the consequence of the interpretation of an expression by reference to the internal law of both the source and residence states is discussed. In the 1977 Model,²¹⁵ Article 15 provides that in some circumstances an employee resident in one state is exempt from tax in the other state in which the employee works for less than 183 days "in the fiscal year concerned". The question can arise which state's fiscal year is relevant. The Report states that the context requires that it is that of the state in which the employee works.²¹⁶ It might be argued that the reason why the source state's law is used is that it is the only state applying the treaty for the purpose of Article 3(2)²¹⁷ because it exempts

200. E.g. Italian treaties with: Egypt (1979), India (1981), Morocco (1972), Tunisia (1979).

201. The treaty with Malta (1984) is the only modern treaty which limits tax sparing to dividends, interest and royalties, with a reference to the treaty articles concerned.

202. See e.g. treaties with China (1985), Nigeria (1989), Pakistan (1980), Sri Lanka (1983), Turkey (1987). In most of these examples the relief comes in a paragraph immediately following references to dividends, interest and royalties by article number.

203. See e.g. treaties with China (1984), Cyprus (1981), Egypt (1980), Jordan (1984), Nigeria (1990), Sri Lanka (1981).

204. See e.g. Turkey (1985) where there is a cross-reference to the credit provision in which dividends, interest and royalties are referred to by article number.

205. See e.g. treaties with: China (1986), Korea (1989), the Philippines (1980), Malaysia (1984), Malta (1981), Mauritius (1990), Sri Lanka (1984), Turkey (1990).

206. See e.g. treaties with Indonesia (1982), Thailand (1990). The treaty with India (1989) does not refer to treaty article numbers as it applies to all types of income.

207. E.g. treaties with: Brazil (1990), Greece (1981), India (1988), Malaysia (1988), Mexico (1993), Nigeria (1991), Pakistan (1982), the Philippines (1989), Sri Lanka (1982), Turkey (1986), Venezuela (1991). However, in the treaties with Tunisia (1995) and Vietnam (1995), the reference is to the type of income rather than to the article number.

208. See e.g. treaties with China (1990), Egypt (1987), Greece (1983), Korea (1980).

209. The point does not arise in Australia (except in the example *supra* in note 201), Italy only in the treaty with Zambia (1972), or the United Kingdom where the credit article does not refer to types of income and the tax sparing is given by reference to provisions of the other state's law. The United States does not give tax sparing relief.

210. See *supra* note 78, paras. 65 and 86(b).

211. Our italics.

212. See *supra* note 81.

213. The German treaty quoted above was after the Report but there are other German examples which were earlier than the Report, see *supra* note 181.

214. "The 183-Day Rule: Some Problems of Application and Interpretation", *Issues in International Taxation*, No 4, (Paris: OECD, 1992); hereinafter: the 183-Day Rule Report.

215. But not the current Model, which refers to 183 days in any 12-month period.

216. The 183-Day Rule Report, para. 21.

217. Article 3(2) is considered in IV.A.4.a and V.A.

the income. On that basis, it is not necessary to assume a conflict between the two states and resolve it by virtue of the context. However, the presence of the discussion means that the Commentary recognizes that, not only the source state, but also the residence state starts by applying its own definitions, and then considers whether the context otherwise requires. It might therefore be argued that the same approach as in the 183-Day Rule Report may apply when a state grants exemption or credit for an undefined category of income referred to by descriptive type because both states potentially interpret the same term.

c. *The OECD Model Estate Tax Convention*

A related problem, although one dealing more with entity characterization rather than characterization of income (or in that case capital), is found in the OECD Model Convention on Estates and Inheritances and on Gifts²¹⁸ which also contains the equivalent of Article 3(2) of the income tax Model.²¹⁹ There are two categories of assets which may, in that Model, be taxed on a situs basis, which corresponds to source in income tax: immovable property and permanent establishments, both of which are defined expressions. The Commentary²²⁰ gives several examples where the two states take different views on whether the asset comes within the articles permitting taxation on a situs basis. These include whether an interest in a partnership, the assets of which comprise immovable property, is itself immovable property or an asset similar to shares in a company. If the situs state takes the former view and the residence state, an exemption state, the latter, the Commentary points out that unrelieved double taxation will arise. If the views of the two states are reversed, so that the residence state (an exemption state) regards the asset as immovable property and the situs state as an interest in a partnership, neither state will tax. Other similar examples arise with unadministered estates, property held in trust, and companies holding immovable property. The Commentary puts forward as a solution that the nature of the interest should be determined by the law of the state in which the deceased was not domiciled.²²¹ Although not an identical problem to the one under consideration, it does deal indirectly with characterization, and it is significant that the Commentary accepts that in principle each state determines whether the situs state should charge and whether the domicile state should exempt by applying its own law, thus potentially leading to double taxation or double exemption. Unlike the income tax Model, the estate tax Model puts forward an amendment to the Model to deal with the problem. If the same is true under the income tax Model, the same problems arise but no solution is provided as there is in the estate tax Model.

4. Discussion of the interpretation of characterization of income by descriptive type

Unlike the position in IV.A. and IV.B., dealing with relief by reference to article number, in cases where income is specified by descriptive type alone, Article 3(2) potentially applies because an undefined term, for example dividends, is used. However, a distinction must be made between the examples in IV.C.1. and IV.C.2. In the former, relating to articles based on Article 23 of the Model, taxation in the source state must be in accordance with the

treaty, while in the latter this is not the case. In the former, in accordance with Article 3(2), the residence state will use its own meaning of the type of income referred to but it is easier to argue that the context requires that this meaning should not be used, as the question whether taxation is in accordance with the Convention can be answered only by considering the application of the convention by the source state. It is suggested that this method of defining the category of income qualifying for credit is less satisfactory than referring to an article number.

In the latter case, in which there is no reference to taxation being in accordance with the Convention, it is more difficult to argue that the context requires that the residence state's meaning should not be used. Here only the residence state is involved. The question is not, as it was in IV.A. and IV.B., "has the source state taxed in accordance with article y?" but "is this a dividend?" In IV.A. and IV.B., both states are potentially interested in applying article y, although, since we are dealing with credit, it must be true that the source state did not consider that the article prevented it from taxing the income. In this case, the category of income is named, but not defined, in the double taxation relief provision only, which is an article applied only by the residence state. For this purpose, it is only the residence state which needs to define that category of income and when it does there is no need to ask whether the source state has taxed in accordance with the convention; the source state never considers the matter. This is particularly so in relation to a tax sparing provision where the source state may be charging no tax or less tax than the treaty permits. The argument for the context requiring the use of a meaning of an undefined²²² descriptive type of income different from that of the residence state's internal law is therefore much weaker than in IV.A. and IV.B.²²³ where the category was specified by making reference to an article number coupled with the requirement that taxation must be in accordance with the Convention.

It is difficult to see how the meaning of an undefined term in the source state²²⁴ is relevant to the interpretation of the examples at IV.C.2., even though the object and purpose of the treaty is to avoid double taxation. Although this method of providing for credit or exemption for a descriptive type of income is not used by the Model, the Commentary²²⁵ does deal with it in the passage originating from

218. Paris, 1983.

219. The version in the 1977 Model.

220. Article 7 Commentary paras. 15-27.

221. This seems to be used mainly by the United Kingdom, see estate tax treaties with: the Netherlands (1979) (the property is included within situs charge in all cases of conflict, which has the same effect since the situs charge will only take effect if the situs state considers it to be within the charge), South Africa (1978), Sweden (1980), Switzerland (1994). It is also found in Austria-United States (1982), and sometimes in more limited form, for example France-Belgium (1959), applying to immovable property only.

222. The position may be different in relation to a type of income defined for the purpose of a particular article, as in the case of dividends, interest and royalties, see text *supra* at note 194.

223. Assuming our alternative interpretation on the basis that Article 3(2) applies.

224. The source state may, of course, be concerned that the treaty does not lead to its having to reduce its tax in circumstances when the residence state does not impose any tax, see, for example, the Canadian case of *The Queen v. Crown Forest Industries Ltd.* 95 DTC 5389.

225. Article 23 Commentary para. 68(b), quoted in the text *supra* at note 81.

the Thin Capitalisation Report, and similar points arise in the 183-Day Rule Report and the Estate Tax Model. These contain indications that the OECD does not regard this method of referring to the type of income as requiring the residence state to relieve double taxation in the case of differing characterization except in circumstances where the context requires, such as the three listed cases of thin capitalization.

The conclusion is that, in the case of references to a category of income by descriptive type, it is likely that, in general, the residence state should use its own meaning. There will be exceptions such as the three examples in the Commentary taken from the Thin Capitalisation Report, where the context otherwise requires. A further exception is the German example in IV.C.1., in which taxation by the source state must be in accordance with the Convention, as the context strongly indicates or requires that the residence state's characterization should not be used. This is similar to the provisions discussed in IV.A. and IV.B.

V. CREDIT OR EXEMPTION PROVISIONS DEALING WITH UNSPECIFIED CATEGORIES OF INCOME

So far, we have been considering references to specific categories of income. In exemption countries Article 23A(1) provides for exemption of the remaining categories of income. Article 23B applies similar wording to all types of income in countries employing the credit method. In both cases, the Model provides that: "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State," the residence state must give credit or exemption. Here the issue under the Model is solely whether the source state may tax in accordance with the provisions of the Convention,²²⁶ rather than any question of characterization of income.

There is no residual category in the Netherlands since treaties generally specify whether each item of income is subject to credit or exemption, thus leaving no residual category,²²⁷ as in the following example:

- Netherlands
2. The Netherlands, when imposing tax on its residents, may include in the basis upon which such taxes are imposed the items of income or capital which, according to the provisions of this Convention, may be taxed in Sweden.
 3. However, where a resident of the Netherlands derives items of income or owns items of capital which according to Article 6, Article 7, paragraph 4 of Article 10, paragraph 3 of Article 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 13, Article 14, paragraph 1 of Article 15, paragraph 3 of Article 18, paragraphs 1 (sub-paragraph (a)) and 2 (sub-paragraph (a)) of Article 19 and paragraphs 1 and 2 of Article 23 of this Convention may be taxed in Sweden and are included in the basis referred to in paragraph 2, the Netherlands

shall exempt such items of income or capital by allowing a reduction of its tax. This reduction shall be computed in conformity with the provisions of Netherlands law for the avoidance of double taxation. For that purpose the said items of income or capital shall be deemed to be included in the total amount of the items of income or capital which are exempt from Netherlands tax under those provisions.

4. Further, the Netherlands shall allow a deduction from the Netherlands tax so computed for the items of income which according to paragraph 2 of Article 10, paragraph 5 of Article 13, Article 16, Article 17 and paragraph 2 of Article 18 of this Convention may be taxed in Sweden to the extent that these items are included in the basis referred to in paragraph 2. The amount of this deduction shall be equal to the tax paid in Sweden on these items of income, but shall not exceed the amount of the reduction which would be allowed if the items of income so included were the sole items of income which are exempt from Netherlands tax under the provisions of Netherlands law for the avoidance of double taxation.²²⁸

The question of interpretation of this residual category arises in the other exemption countries represented (Belgium, France, Germany and Switzerland), and in Italy, the only credit country represented which does not give credit by reference to internal law rules providing for relief in cases of differing characterization. Typical examples of treaty provisions from those countries are as follows:

- | | |
|---------|--|
| Belgium | ...double taxation shall be avoided as follows:...Where a resident of Belgium derives income not mentioned in (2) below [credit] which in accordance with the provisions of the Convention may be taxed in Italy, Belgium shall exempt this income from tax.... ²²⁹ |
| France | Double taxation is avoided as follows:...Income other than that referred to in sub-paragraph (b) below [credit] shall be exempt from the French taxes mentioned in sub-paragraph (a) of paragraph 3 of Article 2 when such income is taxable in Norway under this Convention. ²³⁰ |
| Germany | It is agreed that double taxation shall be avoided in accordance with the provisions of the following paragraphs.... Unless the provisions of subparagraph (b) [credit] apply, there shall be excluded from the |

226. See the quotation from Article 23 of the Model in III.

227. There is an exception in the treaties with China (1987), where categories are specified for credit and exemption is a residual category, and the USSR (1986), where only the exemption method is used.

228. Netherlands-Sweden (1991); the article numbers follow the OECD Model up to Article 19 and then there is an additional Article 20 on professors and teachers, after which the article numbers are one higher than in the Model. This example is the same as the double taxation relief article in the Netherlands Model Treaty.

229. Belgium-Italy (1983).

230. France-Norway (1980).

base upon which German tax is imposed any item of income from sources within the Italian Republic and any item of capital situated within the Italian Republic which, according to this Convention, may be taxed in the Italian Republic....²³¹

Switzerland

...double taxation shall be avoided as follows:...(a) Where a resident of Switzerland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in Poland, Switzerland shall, subject to the provisions of subparagraph (b) [credit], exempt such income or capital from tax....²³²

Italy

...double taxation shall be avoided as follows:...Where a resident of Italy derives items of income which may be taxed in France, Italy, in calculating the income taxes mentioned in Article 2 of this Convention, may include in the taxable base for such taxes those items of income, unless specific provisions of this Convention provide otherwise.

In such case Italy must deduct the income tax paid in France from the taxes so calculated, but the amount of the deduction may not exceed that part of the Italian tax attributable to those items of income in the ratio of those items to the total income....²³³

It is interesting that in all these cases the wording of the article states that "double taxation shall be avoided". A stronger argument than under the Model's wording can therefore be made against an interpretation which does not have this effect because when each state uses its own characterization it can lead to double taxation (or double exemption in an exemption state). Apart from this change, these examples are not materially different from the Model. The practice in these countries will be considered after considering the position under the wording of the Model.

A. Whether Article 3(2) applies in the residence state

The question whether the source state has taxed the income in accordance with the provisions of this Convention is not one with which Article 3(2) is concerned in the residence state. The expression "income...which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State" does not contain any undefined term, certainly not one which has a meaning under the residence state's tax law. Article 3(2) does not say that the question whether income has been taxed in accordance with the Convention must be considered from the point of view of the state applying the treaty; it says that as regards the application of the Convention by a Contracting State undefined terms have the meaning given by that state's law for the purposes of the taxes to which the Convention applies. Unlike IV., where a category of income was specified by one of three methods, here there is no specific reference to any category of income. The question is simply whether the source state may tax this item of income in accordance with the treaty. There can be

only one correct interpretation of the treaty; the answer to the question must be "yes" or "no", not "yes, so far as the source state is concerned", and "no, so far as the residence state is concerned". If Article 3(2) is inapplicable, there is no cause for the residence state to apply its own definition of the income in question,²³⁴ and Edwardes-Ker's arguments²³⁵ against Article 3(2) applying only in the source state do not arise. The expression must be construed in the light of the ordinary methods of treaty interpretation.

Article 3(2) will, of course, be applicable in the source state, but because we are considering relief from double taxation, we shall assume that the treaty did not prevent the source state from taxing that category of income, seen from the point of view of the source state.

B. Interpretation of credit and exemption articles without recourse to Article 3(2)

We turn to consider the interpretation of the expression "income...which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State" on the basis that Article 3(2) is inapplicable. The ordinary meaning of the terms in their context indicate that this is a question for the source state: may the source state tax this income in accordance with the provisions of the Convention? As before, we emphasize that this does not prevent the residence state from arguing that the source state has not correctly applied the treaty from the source state's point of view. The residence state is not the source state and what it would have done if it had been the source state is irrelevant. Before applying the treaty, in all cases in a credit state, and in an exemption state if internal law exemption does not apply, the residence state potentially taxes the income under internal law and it may therefore need to categorize the income for purposes of internal law only. It is a small step for the residence state to say that, since it would tax the income under a category which the source state is not entitled to tax under the treaty, it should therefore not give any credit or exemption. An exemption state which gives exemption under internal law will indeed have to ask the question whether under the residence state's internal law the income falls within a category which the residence state exempts under internal law. As we have pointed out in II.C., this may lead to double exemption which the treaty cannot correct. However, if exemption is not given under internal law it is still necessary to apply the treaty to see if a different result obtains. It is not a logical step for the residence state to categorize the income under its law when deciding whether to give credit or exempt the income under the treaty because no issue of characterization arises in doing so. The question to be answered is solely whether the source state may tax this item of income in accordance with the treaty.²³⁶

231. Germany-Italy (1989).

232. Switzerland-Poland (1991).

233. Italy-France (1989).

234. See the German case in the text *supra* at note 245 for an example of a court using the equivalent of Article 3(2) of the Model.

235. See text *supra* following note 151.

236. See the example in the text *supra* at note 97 of Canada taxing as interest income which the source state has categorized as dividends under thin capitalization rules, but giving credit for the dividend withholding tax imposed by the source state.

Since in all the cases we are considering, the normal treaty wording adopted by countries in practice is that "double taxation shall be avoided", it is suggested that an interpretation should take this into account as part of the context and not give the article a meaning which fails to have this result which can occur if the residence state uses its own characterization of the income.

1. Object and purpose

As we have said already in relation to specified categories of income, the object and purpose of the treaty is to prevent double taxation, which points to the residence state not applying its own definition of the type of income which is likely to be different from the source state's definition. It can be strongly argued that the residence state should not use its own definitions under the wording of the Model to determine whether it would have taxed that income in the way it was taxed by the source state as this could lead to double taxation, or (in an exemption state) to no taxation which cannot be a purpose of the treaty, either. This argument is stronger where the treaty article itself states that "double taxation shall be avoided" in accordance with its provisions. An interpretation which has the opposite effect cannot be in accordance with the purpose of the treaty.

2. Supplementary means of interpretation

The object of eliminating double taxation is particularly important when the wording is based on the Model.²³⁷ There would be little point in drafting a Model which failed to avoid double taxation in the not-uncommon cases where the characterization of the income differed in each state. This is particularly so since the Model contains Article 3(2) with its obvious scope for different characterization of income in each state. At the very least, if the OECD had found it impossible to agree on a wording of Article 23 which prevented double taxation in cases of differing characterization of income, the Commentary would surely have issued a warning. In fact, the Commentary suggests the opposite by making no distinction between the credit provisions in the Model relating to dividends and interest²³⁸ and those relating to this residual category. The Commentary to the credit part of the exemption method dealing with Articles 10 and 11 refers one to the Commentary on the credit method for its interpretation.²³⁹ According to our reading of the Commentary about thin capitalization,²⁴⁰ the Model relieves double taxation in cases of differing characterization by the residence state of the defined term *dividends* in relation to thin capitalization where the definition of dividends refers in part to the law of the source state (the state of residence of the company). The cross-reference to the part of the Commentary dealing with credit generally implies that the same is true of unspecified categories of income even though these deal with undefined categories of income.

The Commentary contains another statement which might be relevant to our topic. It says this in relation to exemption states:

The state of residence must accordingly give exemption whether or not the right to tax is in effect exercised by the other State. This method is regarded as the most practical

one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State.²⁴¹

The justification for exempting income which is taxable, as opposed to taxed, in the source state, which is given in this quotation is that it avoids the necessity of the residence state making investigations of the actual taxation position in the source state. However, since the previous paragraph of the Commentary quotes from Article 23 that the source state tax must be in accordance with the Convention, the residence state is entitled to ensure that this is the case, and so some investigation into the source state's tax position is still necessary. It seems that the Commentary is not considering differing categorization at this point but merely stating that the residence state should exempt income even though the source state does not exercise its right to tax. This will lead to double exemption, but this is caused not by differing categorization, but simply by the source state not exercising its right to tax.

3. Conclusion on unspecified categories of income

The expression "income...which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State" is, in accordance with the ordinary meaning of the terms in their context and in the light of the object and purpose of the treaty, a question for the source state only. This view is supported by the Commentary in making the cross-reference to the credit article in discussing credit for dividends and interest, and by the lack of any statement about the danger of double taxation in cases of differing characterization. This conclusion, that the question whether income may be taxed in the source state is a matter for the source state only, is stronger in actual treaties which, unlike the Model, include the words "double taxation shall be avoided" in the relief article.

C. Country practice

In granting exemption, Belgium, Germany, France and Switzerland, in spite of the fact that each adopts the wording that "double taxation shall be avoided" in the relief article, do not accept the argument set out above and apply their own meaning of the category of income. It should be noted that France and Switzerland give exemption under internal law and Belgium gives a reduced rate of tax under internal law, which could be regarded as a partial exemption. It is suggested that this factor may influence those countries to apply the same interpretation to treaty exemption as they do to internal law exemption which requires income to be categorized by the residence state.

Germany does not give exemption under internal law but does so in treaties and therefore the issue is entirely one of

237. See Article 1 Commentary para. 7. The title of Article 23 is "Methods for elimination of double taxation."

238. Since the credit provisions in Article 23A(2) of the Model relate only to defined terms this statement does not help in relation to the interpretation of references to undefined categories, which we have considered in IV.

239. Article 23 Commentary para. 47.

240. See IV.A.1.a.

241. Article 23A Commentary para. 34.

treaty interpretation. A number of German treaties contain a provision which is necessary only if Germany, as the residence state, regards the question whether the other state has taxed in accordance with the treaty as one which should be answered by applying German law:

The Federal Republic of Germany shall avoid double taxation by a tax credit as provided for in paragraph 2 (b) of Article 23, and not by a tax exemption under paragraph 2 (a) of Article 23,

(a) if in the Contracting States income or capital is placed under differing provisions of the Convention or attributed to different persons (other than under Article 9 (Associated Enterprises)) and this conflict cannot be settled by a procedure pursuant to Article 25 and

(aa) if as a result of such placement or attribution the relevant income or capital would be subject to double taxation; or

(bb) if as a result of such placement or attribution the relevant income or capital would remain untaxed or be subject only to inappropriately reduced taxation in the United States and would (but for the application of this Paragraph) remain exempt from tax in the Federal Republic of Germany....²⁴²

This provides that, in cases of differing characterization of income leading to double taxation or double exemption, Germany gives credit instead of exemption. The provision is not reciprocal, which strongly indicates that the treaty partners did not have the same problem.²⁴³ In spite of the opening words, this provision may not be limited to cases where Germany would have granted exemption. In view of item (aa), it presumably applies when Germany considers that the income should not be taxed in the other state and Germany accordingly taxes it. It may also apply when Germany would have given credit but for a lower amount, for example Germany thinks an item of income is a dividend and would give credit for 15% tax but the United States has taxed it at full rates as another category of income. The implication is that Germany, as the residence state, applies its own characterization of income in giving exemption.²⁴⁴

We have already given an example of this provision applying where Germany characterizes a payment of interest by a US partnership to a German resident partner as business profits while the United States characterizes it as interest. This issue arose in a German case²⁴⁵ under the former US treaty (1954) in which it was decided that the equivalent of Article 3(2) of the Model was applicable in a case of differing characterization but that the context otherwise required that the residence state characterization should not be used. The case concerned interest paid to a German resident partner from a US limited partnership. The United States allowed a deduction for the interest on the loan in computing the profits for US income tax purposes, and no withholding tax was payable on interest under the treaty. Article XV of the treaty provided for exemption in Germany for "any item of income from sources within the United States which according to this Convention is not exempt from tax by the United States", unless the credit provisions applied to the income. This was not very different from the Model's wording "income which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State". The interest in ques-

tion could not on any basis come within the credit provisions which were specified by type to apply only to dividends, wages and pensions. Accordingly, the only issue should have been whether the income was exempt from US tax. It clearly was exempt in the United States as the amount was deductible as interest in computing the partnership profits in the United States, and interest was not liable to withholding tax under the treaty. The court approached the problem by looking first at the German characterization of the income as business income, presumably as the category under which it was taxed as a matter of internal law. Industrial and commercial profits were defined in the treaty to exclude interest, which itself was an undefined expression. The court applied the equivalent of Article 3(2) to categorize the income as business income under internal law, but decided that the context of the treaty, particularly the exclusion of interest from the definition of industrial and commercial profits, required that internal law should not be used. This involved categorizing the income for treaty purposes as interest in the context of the treaty; this happened to follow the US internal law definition of interest, but that was coincidental. This case cannot therefore be support for the proposition that Germany will follow the source state's characterization, rather the reverse, since if the context had not otherwise required, Germany would have presumably used its own characterization, as suggested by the treaty provision considered above.²⁴⁶

Recent French treaties²⁴⁷ have also contained provisions which avoid double exemption by not exempting income which the source state does not tax, as in the following example:

Both the Contracting States retain the right, in accordance with their laws, to tax income other than dividends of their residents, the taxation of which has been assigned to the other Contracting State but which have not effectively been taken into account for the tax base in that State.²⁴⁸

No doubt this provision mainly deals with double exemption caused by the source state not exercising its right to tax under the treaty, as is pointed out by the Commem-

242. Germany-United States (1989) Protocol para. 21. Other examples are found in German treaties with: Italy (1989, in para. 17 of the Protocol), Mexico (1993, in para. 12 of the Protocol), and Canada (1981, in para. 13 of the Protocol). It is interesting that these states all use the credit method of relief under treaties and do not have the same problem. The United States and Canada in all their treaties, and Mexico in some of its treaties, including the treaty with Germany, refer to internal law for credit rules, see II.

243. In the case of the United States and Canada this is because of the treaty reference to internal law which provides for relief in cases of differing characterization, see II. Germany's interpretation is criticized by Déry and Ward in the Canadian National Report in the IFA *Cahiers* (see *supra* note 145), at 284, in which it is suggested that it is based on a wrong interpretation of Article 3(2) unless it is limited to cases where Article 3(2) cannot be applied because the term in issue does not have a meaning in the source state's law, or the characterization issue arises otherwise than because of the meaning of a term.

244. Germany deals with the other major problem of exemption by requiring business activity in cases of low taxation source states.

245. BAH 27 February 1991, *BSiBl* 1991 II 444.

246. See *supra* note 242.

247. With Austria (1993) and Sweden (1990). This seems to be new treaty policy, see P. Forget, "A Comment on French Treaty Policy in the Context of International Economic Integration" 49 *Bulletin for International Fiscal Documentation*, 1995, at 385, 388.

248. France-Sweden (1990).

tary.²⁴⁹ However, it does also cover double exemption caused by France applying its internal law exemption by categorizing income in accordance with its law in accordance with the principle of autonomy of interpretation. But since France gives exemption under internal law, this provision does not indicate that this is the correct interpretation of the treaty; rather it is correcting a problem caused by internal law. Such a treaty provision is valid in France because in France a treaty can increase taxation. In a French decision of the Conseil d'Etat,²⁵⁰ a US recording company paid royalties to the daughter of a deceased conductor resident in France without deducting any withholding tax in accordance with the treaty, presumably on the basis that it was a copyright royalty in a literary or artistic work which only the residence state could tax. France considered that the royalty was not derived from copyright (a condition for exemption from tax in the source state required by the treaty) under French tax law by applying Article 3(2), so it was not a royalty within the treaty. It was, therefore, other income which, in this treaty, unlike the Model, only the United States, as source state, could tax. The court held that the income was exempt in France, resulting in double exemption.

Switzerland, which, like France, gives exemption under internal law also applies its own characterization of income when granting exemption under a treaty.

Belgium, which gives a reduced rate of tax, rather than exemption under internal law, applies its own characterization of income to determine whether to grant exemption. There is language in the Belgian official commentary on tax treaties which suggests this.²⁵¹ This seems to be the practice of the Belgian tax authorities and of the Belgian courts in some cases. Under Belgian case law in domestic matters, all income which a director receives from the company of which he is a director is taxed as director's fees. The Belgian tax authorities seem to apply this reasoning in cross-border situations involving a Belgian resident who is a director of a non-resident company. This can give rise to double exemption where, for example, the source state characterizes the income as a pension and exempts it under the equivalent to Article 16 of the Model.²⁵² Belgian courts often apply domestic law in interpreting treaty terminology. A good example is the *Velasquez* case, in interpreting the term "exemption" in Article 24 (corresponding to Article 23 of the Model) of the Belgium-Netherlands treaty.²⁵³ A more recent example involves Netherlands-source sickness allowances paid to residents of Belgium who have been working in the Netherlands for a period exceeding 183 days. Under Netherlands tax law such allowances are characterized as salaries and wages. Hence, the Netherlands taxes the allowances under Article 15 of the treaty. A Belgian court ruled that sickness allowances are, under Belgian domestic law, not characterized as salary but form a distinct category of income. Therefore, the court held that Belgium should not exempt such allowances as Article 21 of the Model entitles the residence state to tax "other income".²⁵⁴

As far as Italy is concerned, the only credit state in which the question arises, we have already mentioned the Germany-Italy treaty provision.²⁵⁵ Since this operates only for Germany, it seems clear that Italy did not see different

characterization as causing a problem. There is no official guidance on this point.²⁵⁶

VI. CONCLUSION

Whether credit or exemption is required to be given in cases where the source and residence states characterize income differently is not a question which can be answered for all cases. First, a distinction must be made for internal law credit, which in many cases will provide for relief regardless of the source state characterization, and internal law exemption, which by characterizing income by reference to the residence state's law may lead to double exemption which the treaty cannot solve. Next, under treaties there are articles which for exemption states provide for credit for certain types of income, such as dividends and interest under the Model but other types of income in some states' treaties. Where the income qualifying for credit is specified by reference to a treaty article number we argue that the question whether income may be

249 Article 23A Commentary para. 34.

250 See the decision of 3 July 1985, Req. 56.091. Edwardes-Ker in *The International Tax Treaties Service*, In-Depth Publishing Ltd. (under Article 12) criticizes this on the basis that the payments were royalties as consideration for other like property or rights in which case the United States could have applied a 5% withholding tax, because France determined whether the payment was in respect of copyright by French tax law which gives a tax benefit to composers, and because France applied Article 3(2) when Article 12 Commentary para. 13 (1977) stated that such payments were royalties (but this is after the 1967 treaty). None of these criticisms affects the point that France applied its own characterization for exemption purposes.

251. Ch. 23, paras. 23-103 stating that (*pro parte*): "Notwithstanding the foregoing, in Belgium the tax treatment of income having its source in a treaty country is to be determined in accordance with domestic law. It results from this that: ...for income which is to be included in the taxable income of a Belgian resident, the method of avoiding double taxation is determined by taking into account the character such foreign source income has under the provisions of Belgian domestic law." As this statement refers to the applicable method of avoiding double taxation, one can conclude that, if Belgian domestic law characterizes income differently from the source state, no exemption will be granted if Belgium considers that it is entitled to tax such (differently characterized) income under the treaty.

252. In the reverse case of a non-resident director of a Belgian company, this rule can give rise to double taxation; Belgium taxes the income as director's fees and the other state may consider it as income which should not have been taxed in Belgium and taxes it again (Parl. Question, 09.01.1987, *Bull.*, V & A, 1986-87, 1441). A similar problem leading to double exemption arose in the Belgian Supreme Court case (21 December 1990, *FGF* 91-28) relating to income from a Belgian *société privée à responsabilité limitée* (*besloten vennootschap met beperkte aansprakelijkheid*) paid to a managing partner resident in the Netherlands. This was categorized by Belgium as "other income" and exempted, and by the Netherlands probably as directors' fees (or possibly as falling within Articles 15, 14 or 7 with the same result) and also exempted. Since then, Belgium and the Netherlands have entered into an interpretative agreement by virtue of which the income is now taxed under Article 16 (Cl. C. 37875, 22.05.1992, *Bull. Bel.*, 1849).

253. Supreme Court, 29.06.1984, *FIF*, 84/164; criticized by *inter alia*: L. Hinnekens, "Velasquez: het arrest van de gemiste kans", *AFT*, 1984, 194; Vogel, *supra* note 144, at 1007.

254. Antwerpen, 20.09.1994, not yet published. It should be emphasized that the court, in applying Belgian domestic law, does so in an incorrect way. Sickness allowances are, under Belgian domestic law, treated as salary (Article 31(4) Belgian Income Tax Code). Even if one accepts that Belgium can apply Article 23 with reference to domestic law, the correct outcome of the case should in any event have been that the income was characterized as salaries, wages and other remuneration within Article 15, which Belgium had to exempt.

255. See *supra* note 242.

256. The reply to the question in the Software Report, see *supra* note 135, suggests that Italy does give credit in cases of differing characterization.

taxed in accordance with the convention under that article number is a question for the source state's characterization, but this does not prevent the residence state from contending that the source state has not correctly applied the treaty from the source state's point of view. In other cases, income may be specified by descriptive type, such as dividends, in provisions providing exemption, or credit for underlying tax, for intercompany dividends. Here, we argue that characterization should be in accordance with the residence state's law. Finally, there is the question of exemption for the remaining types of income, and credit for all types of income. No type of income is specified and

the issue is whether income may be taxed by the source state in accordance with the convention. We argue that this is a question to be answered by the source state, again on the basis that the source state has correctly applied the treaty from its point of view. This last point is not accepted by most exemption countries.

Since differing characterization of income is not uncommon it would be useful if the OECD Commentary could deal specifically with this issue. We also suggest that the Commentary to thin capitalization has become muddled in the process of incorporating the conclusions of the Thin Capitalisation Report and should be rewritten.

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