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Tax Treaty Problems Relating to Source

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I. INTRODUCTION

In the first part of this article we consider the relevance of source in relation to taxing rights under the OECD Model Tax Convention, particularly in relation to the Model's provisions relating to the source of interest which can result in a different source in two different treaties entered into by the recipient's state of residence. In the second part we consider double taxation relief articles, not based on the Model, but in frequent use in practice, which require that income has a source in the other state as a condition of giving relief.

II. SOURCE IN RELATION TO TAXING RIGHTS

A state decides on the extent to which under its internal law it taxes the income of non-residents. This may be expressed either by specifying that the source¹ of certain items of income is in the taxing state, or by specifying the items of income which are taxable in the hands of a non-resident. The effect is the same, and both could be, and in this article are, described as definitions of source.² The OECD Model uses both methods in granting the source state's right to tax. Generally it lists the items of income which a source state may tax in the hands of a resident of the treaty partner state, such as business income attrib-

utable to a permanent establishment in its state, dividends paid by a company resident in its state, and remuneration from an employment exercised in its state. In the case of interest, which may be taxed by the source state if it arises in that state, a source rule, which will be considered below, is specifically provided.³ In addition, there are references to source in Articles 4(1) (resident) and 20 (students), while Articles 10 (dividends), 11 (interest), 12 (royalties) and 21 (other income)⁴ refer to income arising in a state, which in the context has the same meaning. Often states

1. Source in this context means geographical source. The United Kingdom uses the expression in internal law in the different sense of the type of income. Canada uses the expression in its internal law in both senses.

2. See also Robert J. Patrick's General Report Rules for Determining Income and Expenses as Domestic or Foreign, *Cahiers de droit fiscal international*, Vol. LXVb (1980): "It is reasonable to suggest that notions of 'domestic' or 'foreign' income become convenient labels for designating activities that are or are not to be subject to tax and for recognising the right of other countries to primary or exclusive taxing jurisdiction."

3. Art. 11(5), see heading A. References herein to the Model and Commentaries are to the text as updated in September 1995. A source rule similar to that of Art. 11(5) is found in relation to royalties in the UN Model, which provides for a withholding tax on royalties. The OECD Model exempts royalties arising in a Contracting State (without defining when they arise), and paid to a resident of the other Contracting State, which is the same wording as used in the interest article. A source rule is also included in treaties by states when reserving a withholding tax on royalties, which is usually the case in treaties made by Australia, Belgium, Canada, Japan and Italy, among the countries represented by the authors.

4. Arts. 10(5) (in relation to profits or income arising in a state out of which dividends are paid), 11(1),(2),(4),(5), 12(1),(3) and 21(1).

will refer in their treaties to other types of income arising in a state. As in the case of internal law, one might, and in this article we shall, describe anything which the Model entitles a state to tax in the hands of a resident of the other treaty state as having a source in the taxing state.

When the taxing state decides in its internal law to tax an item of income in the hands of non-residents it may well not be on the same source basis as that permitted by the Model because there are no universally accepted definitions of source.⁵ If internal law of the source state is wider, the treaty will cut it down; to the extent that it is narrower, the source state may not tax. If the residence state is an exemption state a narrower source concept in internal law can give rise to no tax in either state. Only in France, Australia and Japan of the states represented by the authors is the combined effect of the treaty and internal law to tax the income which the treaty permits the source state to tax but which the source state does not tax in the absence of the treaty.⁶ In France, internal law specifically provides for this:

France Notwithstanding any provision to the contrary in the *Code Général des Impôts*, all income the taxation of which is allocated to France by a double taxation Convention is liable to income tax on natural persons or corporation tax in France.⁷

Japanese internal law can also create a tax charge by reference to the treaty. It does so, not by making the treaty charge additional to that under internal law, as in France, but by substituting the treaty source rules for those in internal law:

Japan In the case where a treaty that Japan has concluded for the avoidance of double taxation with regard to taxes on income has a provision the effect of which is different from the provisions of the preceding Article [domestic source income], the domestic source income shall be determined in accordance with the provision of the treaty with respect to those corporations to whom the treaty applies to the extent such provision so differs. In such case, if the treaty provides for domestic source income in the place of items (ii) through (xi) of the same Article [list of domestic source income], the domestic source income as provided for in the treaty shall be deemed to correspond to the domestic source income as provided for in those items in the application of such part of this law as concerns the matters provided for in those items.⁸

Australia is in the same position as Japan. Australian treaties normally contain provisions which apply the treaty source rules for the purpose of internal law as well as the treaty, as in this example:

Australia Income derived by a resident of Norway which, under any one or more of Articles 6 to 8, Articles 10 to 18 and Article 21 may be taxed in Australia, shall for the purposes of the income tax law of Australia be deemed to be income from sources in Australia.⁹

Such a source rule entitles Australia to impose tax in a case where the treaty moved the source into Australia when internal law says that the source is outside, a potential example being where an Australian resident pays interest on a debt incurred for the purpose of a permanent establishment outside Australia.¹⁰ But in cases where this arises, the legislation giving effect to the treaty prevents this charge to tax from occurring, as will be seen in the next section.¹¹ One would expect Japan and France to have the same difficulty when the treaty moves the source into the state from outside, where internal law determines it to be, but, so far as source is concerned, this does not seem to have occurred in Japan,¹² and in France the tax authority has not taken a final position on the matter.

5 For source rules generally, see Robert J. Patrick's Rules for Determining Income and Expenses as Domestic or Foreign, *Cahiers de Droit Fiscal International*, Vol. LXVb (1980). See also Prof. Klaus Vogel "Worldwide vs Source Taxation of Income - a Review and Re-evaluation of Arguments", *Intertax* 1988/8-9, at 223. Prebble gives an example of interest paid on a loan from a German resident to a French resident pursuant to a contract negotiated and signed in England, secured over property in Canada and the principal used in a business carried on in the United States payable by automatic transfer between accounts in the same Hong Kong bank: Ectopia, "Tax Law and International Taxation" [1997] *BIR* 383. For a recent example of the development of source rules, see the Privy Council decision from Hong Kong *Comr of Inland Revenue v. Orion Caribbean Ltd* [1997] STC 923.

6 In addition to the examples in the text, there are a few other examples of tax being increased by treaty; for example, in the Netherlands, treaties relating to international organizations may deem a person to be a resident when he would not be resident under internal law, and in Switzerland estate tax is imposed on certain assets by the combined effect of an estate tax treaty and cantonal law (see, for example, Art. 4(5)(c) of the Geneva estate tax law which provides that other assets located in Geneva are subject to estate tax if an estate tax treaty provides that these assets can be taxed in the state in which they are located). In addition, the method of allocation of profits to a permanent establishment of banks or insurance companies under a treaty could give a higher figure than under internal law. Canada passes a statute for each treaty and so has the same legislative authority to impose tax as the Income Tax Act (ITA) and therefore it is theoretically possible for the treaty to impose tax but in practice this does not happen. In fact, Revenue Canada, in published Ruling No. 9621423, has taken the position that tax treaties are not to be interpreted in a way that increases tax liabilities. The ruling related to a purchase of own shares by a UK company from a Canadian resident which was a distribution from the UK point of view but not treated as a dividend in Canada.

7 Act of December 29, 1959, codified in Arts 4 bis, 165 bis, 209-I of the *Code Général des Impôts* read with Art. 55 of the Constitution.

8 Corporation Tax Law, Art. 139 (corporations). There is an identical provision, except for the cross-reference, in Income Tax Law, Art. 162 (individuals).

9 Australia-Norway (1982). We shall normally restrict our examples of treaties to post-1980 treaties since earlier ones may not reflect current treaty policy. The provision is expressed differently in the Australian treaties with: Hungary (1990), Indonesia (1992), Poland (1991), Spain (1992), but the effect is similar. In Australia-China (1988) this provision is not in the treaty, but in the International Tax Agreements Act, s. 11S(2) which gives effect to the treaty.

10 This example does not arise with the treaty with Norway or with most of Australia's treaties as the source of interest paid by a permanent establishment under the treaty does not follow the Model.

11 See text at note 60.

12 See text immediately following note 49.

A. Article 11(5) of the Model

The Model contains a source rule for interest in Article 11(5) which can give rise to problems of dual source:

Interest shall be deemed to arise in a Contracting State when the payer is a resident¹³ of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State¹⁴ in which the permanent establishment or fixed base is situated.

The first sentence of Article 11(5) determines the source of interest¹⁵ to be the state of residence of the payer. The second sentence has priority over the first sentence in two situations: first, where the payer, being a resident of one of the states, has a permanent establishment in the other state, and secondly, where the payer is not a resident of either state but has a permanent establishment in one of the states.¹⁶ Where the indebtedness is incurred in connection with, and borne by, the permanent establishment¹⁷ (to which, for simplicity, we shall refer somewhat inaccurately as interest *paid by* the permanent establishment), the source is the permanent establishment state and not the payer's residence state.¹⁸ This case arises most commonly where the permanent establishment of a bank pays interest on deposits made from outside the permanent establishment state. The effect of the second sentence having priority over the source rule in the first sentence is therefore either to move the source across to the other state, which can have the effect of making the treaty apply if the payer and recipient of the interest are resident in the same state, or to move the source into one of the treaty states if the payer is a resident of neither state but the interest is paid by a permanent establishment in one of the states to a recipient resident in the other state. But the second sentence does not have the converse effect of moving the source from one of the states to outside both states where the payer is a resident of one of the states but the interest is paid by a permanent establishment outside both states, because of the requirement in the second sentence that the permanent establishment must be *in a Contracting State* for the source to be moved to the permanent establishment.¹⁹ This is not unexpected because, if the effect of the second sentence were to move the source outside the two states, the payer's residence state would give up its right to tax the interest. Whether the permanent establishment state taxed the interest would depend on its treaty, if there is one, with the recipient's residence state.

The effect of applying Article 11(5) in more than one treaty is to cause a problem of dual source, even when there is a treaty between the permanent establishment third state (P^S, the superscript indicating that it is the permanent establishment of the payer resident in state S) and the recipient's residence state (R). The treaty between the payer's residence state (S) and the recipient's residence state (R) will determine the source of the interest to be in the payer's residence state (S) in accordance with the first sentence of Article 11(5).²⁰ The treaty between the permanent establishment state and the recipient's residence

state (the R-P^S treaty) will determine the source of the interest to be the permanent establishment state (P^S) in accordance with the second sentence, a case of importing the source into one of the states where the payer is a resident of neither state. The recipient's residence state will have made two treaties which determine the source of the interest to be in two different states and may be obliged to give relief for both taxes because in both cases the tax will be in accordance with the provisions of Article 11.²¹ The charge to tax in both states is not prevented by Article 21²² because that article applies only to income not dealt with by other articles of the treaty and in both treaties the interest falls within Article 11.²³ The problem of dual source will matter in practice only if under internal law the payer's residence state regards the interest as having a source there when the interest is paid by a permanent establishment outside that state (of which the United

13. The words "that State itself, a political subdivision, a local authority or" were included before the words *a resident* in the 1963 Draft and the 1977 Model and in later versions up to 1995. They were deleted in the 1995 update as a drafting change consequent on the change to Art. 4 to the effect that the state, its political subdivisions or local authorities are treated as residents. If the payer is exempt from tax under internal law he is not a resident and this provision does not deal with the source of interest.

14. The OECD 1963 Draft has *Contracting State* instead of *State*, but there is no difference in meaning as the permanent establishment must be in a Contracting State.

15. The same issue arises in relation to royalties in treaties which impose a withholding tax on royalties and contain a similar source rule, see *supra* note 3.

16. Most of Art 5 applies to a permanent establishment of a third state resident because the definition refers to a fixed place of business through which the business [activity would reflect the meaning of the French text better and avoid the double reference to business] of an enterprise (not an enterprise of a Contracting State) is carried on. But Art. 5(7) is not expressed in terms which exclude a controlled company of a third state resident because it is drafted in terms of a company resident in one state which controls, or is controlled by, a company which is a resident of the other state or which carries on business in the other state. This leaves open the position of a third state resident company controlling a company carrying on business through a permanent establishment in one of the treaty states. The definition in Art 5 is not subject to the context otherwise requiring. Some US treaties made in the 1970s and early 1980s, and current Australian treaties, provide that the definition of permanent establishment applies to a resident of a third state, see *infra* note 63. Canada-United States (1980) and some recent Canadian treaties do the opposite by changing the equivalent of Art 5(1) of the Model to read "... 'permanent establishment' means a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on," with the result that the whole of the definition of permanent establishment applies in terms only to a resident of one of the states.

17. For the connection required by the permanent establishment, see Art. 11 of the Commentary (hereinafter: Comm) para 27.

18. This is the opposite of the problem discussed in the OECD Report on Triangular Cases, in *Issues in International Taxation* No. 4, 1992, which deals with the permanent establishment being the recipient of the income.

19. See also Art. 11 Comm para 28.

20. This aspect is discussed by Marco Lombardi in "Triangular Situations: A Case of Double Source Taxation of Interest and Royalties", 51 *Bulletin for International Fiscal Documentation* 4 (1997), at 177.

21. Art. 23A(2), 23B of the Model.

22. Or Art. 7 if the interest is business income. Where the second sentence of Art. 11(5) is not included, as in Belgium-France (1964), the result is that the treaty prevents Belgium from charging tax under its internal law on interest paid by the Belgian permanent establishment of a French resident, but the official commentary to Belgian treaties states that the internal law rate of withholding tax is payable: Off Comm ITT 11/507.

23. Art. 11 Comm para 6, stating that the article does not apply to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State, deals with interest which is income of the permanent establishment. If the interest is part of business profits and there is no permanent establishment, Art. 7 will prevent its being taxed in the source state.

States,²⁴ Italy and, in some circumstances, Australia, Canada, the Netherlands and Switzerland, are the only examples among the countries represented by the authors),²⁵ and the permanent establishment state regards the source as in its state,²⁶ which is more common among the countries represented. The problem of dual source is potentially more serious in countries, such as France, Japan and Australia, where the combined effect of the treaty and internal law is to impose tax by converting the treaty source into the internal law source.²⁷

In the residence state the requirement to credit taxes in both states S and P^S may give rise to limitations in the relief because the rate of tax in the residence state may be insufficient, and to limitations on the total credit which may be claimed. In Belgium and Canada, when they are residence states (R), the problem of dual source can result in double taxation as the internal law credit for foreign taxes on interest in Belgium, and non-business income in Canada, is limited to 15%.²⁸ The aggregate source taxation imposed by states S and P^S can well exceed 15%.

The Commentary²⁹ recognizes that Article 11(5) does not solve the problem of dual source but notes that it is not possible in a bilateral convention for state S to give up its right to tax in favour of a permanent establishment in a third state. It points out that

Paragraph 5 [of Article 11] provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third State and the interest is borne by that establishment...

The risk of double taxation just referred to can only be fully avoided through a bilateral convention containing a similar provision to that in paragraph 5, between the Contracting State of which the payer of the interest is a resident and the third State in which the permanent establishment paying the interest is situated, or through a multilateral convention containing such a provision.

Moreover, in the case – not settled in paragraph 5 – where whichever of the two Contracting States is that of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent [states S and P^S], together with, where appropriate, [state R] from concerting measures to avoid the double taxation that would result from such claims. The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph (5).³⁰

The argument in the Commentary must be that if the treaty between the payer's residence state and the permanent establishment state (the S–P^S treaty) contains the second sentence of Article 11(5), it determines the source of the interest to be in state P^S instead of state S and prevents state S from charging any tax. The argument presumably continues that, while as between states S and R, there is nothing to prevent state S from taxing the interest, by virtue of its agreement with state P^S, state S cannot exercise its right. This argument does not seem to us to be correct because the S–P^S treaty, according to Article 1, applies

only where a person is resident in at least one of the states, which is not the case in the treaty between the payer's residence state and the payer's permanent establishment state. As the Commentary makes clear, Article 1 must mean that it is the recipient of the income who must be a resident of one of the states, and not that it is sufficient for the payer of the interest to be a resident.³¹ This interpretation is supported by the OECD Report on Triangular Cases which states that the S–P^S treaty could be applied to this case only if it provided expressly for the treatment of triangular cases, thus overriding Article 1.³² In any event, Article 11 deals only with "interest arising in a Contracting State and paid to a resident of the other Contracting State,"³³ which is not the case under the S–P^S treaty. The quoted wording in the Commentary dates from the OEEC Fiscal Committee's Fourth Report of 1961,³⁴ about which the same criticism could be made since Article 1 dates from the OEEC Fiscal Committee's Third Report of 1960.³⁵ If the S–P^S treaty had applied, the second sentence of Article 11(5) would determine whether the source of the interest is in state S or P^S, but the treaty does not apply and there is nothing to prevent state S from taxing the interest paid by a resident of state S.³⁶ It is therefore suggested that including Article 11(5) in all three treaties between states S, P^S and R is not the solution. The above quotation envisages that it may be appropriate for state R to be included in the agreement with S and P^S, although in terms of a bilateral convention it is sufficient if such a provision is contained in the S–R treaty. This approach is the alternative

24. Since 1984 and the exemption of portfolio interest in the United States the tax charge in the payer's residence state is limited to interest paid to a foreign bank or a foreign significant shareholder.

25. States which, as state S, do not tax the interest when the debt is incurred for the purposes of a permanent establishment outside the state, either because they do not regard the interest as having a source there or because they do not have a withholding tax on interest, include: Australia (so long as the debt is not secured on property in Australia), Belgium, France, Canada (so long as the interest is not payable in Canadian currency and the lender is dealing at arm's length), Germany, Japan, Netherlands (except for interest on profit-sharing bonds), Switzerland (except for interest on a bond issue), United Kingdom.

26. States which, as state P^S, do not tax the interest, either because they do not regard the interest as having a source there or because they do not have a withholding tax on interest, include: Germany (except in the case of a banking institution), the Netherlands, Switzerland (except for interest paid by banking institutions on deposits).

27. See text at and following note 6.

28. In Canada the excess tax can be deducted from the income.

29. Art. 11 Comm paras 28 to 30. If there is no tax at source on interest under the S–R treaty, Art. 11(5) is unnecessary but, as pointed out in Art. 11 Comm para 31, the problem is the same if there is a permanent establishment in a third state.

30. Art. 11 Comm paras. 28–30.

31. Art. 1 Comm para 1 explains that treaties which are not restricted in their application to residents but apply to taxpayers of the Contracting States are wider in scope since they are applicable to persons who, although not resident in either State, are liable to tax on part of their income in each of them (which is precisely the case under the S–P^S treaty).

32. See *supra* note 18, para 42.

33. Art. 11 Comm para 6 provides that: "The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State."

34. Commentary on Art. XXI paras. 28 to 30.

35. Art. XVIII.

36. The non-discrimination article of that treaty does, however, apply to the deductibility of the interest by the permanent establishment, which must not be less favourable than a resident of the permanent establishment state. See the text around note 69 in relation to non-discrimination.

solution put forward by the Commentary³⁷ of varying the second sentence of Article 11(5) to read:

Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment or fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

If this alternative wording is contained in the S-R treaty, state S is prevented from taxing the interest by Article 21. The interest has not been dealt with in Article 11³⁸ because it does not arise in state S; only the P^S-R treaty, if there is one, is applicable.³⁹ The effect of the alternative wording is to apply the S-R treaty definition of permanent establishment in relation to a third state, as if the permanent establishment were in a Contracting State. There is a problem about doing so because part of the definition of permanent establishment, the part which includes agents and excludes controlled companies,⁴⁰ is stated to apply where the permanent establishment is in a Contracting State, and is not in terms applicable to a permanent establishment in a third state, although it may be that these provisions should be applied to an establishment in a third state by analogy. Presumably this alternative solution is not included in the Model as the preferred solution because the permanent establishment may not be in a treaty country, in which case state S has given up its right to tax in favour of another state with which it has no tax treaty and which may not tax the income.⁴¹

1. Examples of treaties fixing the source of interest in a third state where there is a permanent establishment

The earliest use of a treaty article which moves the source out of the Contracting States into a third state where the payer has a permanent establishment which pays the interest was, so far as we can discover, the former United Kingdom-Japan treaty (1962), of which there are some extensions to dependent territories of the United Kingdom still in force.⁴² It was also used in some other 1960s treaties by both of those countries,⁴³ with the latest use being by Japan in 1971. In addition to Singapore's treaty with the United Kingdom (1966), the same provision is found in Singapore-Norway (1966). These treaties all contained the following, or similar, wording:⁴⁴

Interest paid by one of the Contracting States, including local governments thereof, or by an enterprise of one of the Contracting States, shall be treated as income from sources within such Contracting State, except that interest (other than that paid on indebtedness in connection with the purchase of ships or aircraft) which is paid:

- (i) by an enterprise of one of the Contracting States with a permanent establishment outside both Contracting States⁴⁵ to a resident or a corporation of the other Contracting State; or
- (ii) by an enterprise of one of the Contracting States with a permanent establishment in the other Contracting State on indebtedness incurred for the use of (or, in the case of a banking business, on deposits made with) the permanent establishment in the conduct of its trade or business and which is borne by that permanent establishment shall be

treated as income from sources within the territory where the permanent establishment is situated.

Adoption of this provision by the United Kingdom or Japan⁴⁶ did not result in their giving up any taxing rights as they do not, when they are the residence state of the payer, charge tax under internal law in these circumstances. Indeed, since Japan imposes tax on the basis of the treaty source rule⁴⁷ one might expect Japan would always adopt the alternative wording in order to prevent tax being charged in Japan, as the payer's residence state, under the Model's wording when the interest is paid by a permanent establishment outside Japan.⁴⁸ It is interesting that Japan started to use the alternative wording in 1962, which was the same year it adopted the provision that the treaty source rule applies for charging tax under internal law. The reversion by Japan to the Model's wording, rather than using this alternative, causes double taxation of the interest, assuming that the permanent establishment state also taxes it, as happens in most states.⁴⁹ This problem does not seem to have arisen in Japan, presumably because the tax charge caused by the treaty is not in practice enforced.

37. Art. 11 Comm para. 30. This wording first appeared in the 1977 Commentary. Although theoretically it also deals with the situation where a resident of neither state has a permanent establishment in neither state, this is of no practical importance.

38. Although part of Art. 11, namely para. (5), is used to determine that the article does not deal with the interest in question.

39. It does not make any difference whether the Model's, or the alternative, wording is used in the P^S-R treaty since in both cases the interest is covered by the second sentence. As before, the terms of the S-P treaty are not relevant. The definition of permanent establishment in the P^S-R treaty may be different from that in the S-R treaty, about which there is a problem of definition in relation to third state residents, see next sentence in the text.

40. Art. 5(5) to (7). The definition is, unlike the definitions in Art. 3, not subject to the context otherwise requiring. Some US treaties made in the 1970s and early 1980s and current Australian treaties provide for the whole definition of permanent establishment to apply to an establishment in a third state, see *infra* note 63, which is an improvement on the Model.

41. This is implied by Art. 11 Comm para. 29.

42. Extensions of former United Kingdom-Japan (1962) to apply to Japan and British Virgin Islands (1970), Fiji (1970), Montserrat (1970), the Seychelles (1970) (terminated in 1982).

43. In the United Kingdom, former United Kingdom-Malaysia (1963), and current United Kingdom-Malaysia (1973, but this provision was deleted by a protocol in 1987), United Kingdom-Singapore (1966); this wording was not used in other UK treaties of the time. In Japan, Japan-Korea (1970) (different wording to the same effect), Japan-Malaysia (1970), Japan-United States (1971), former Japan-Thailand (1963). This amounts to 5 out of 18 Japanese treaties between 1962 and 1971, interestingly not including Japan-Australia (1969), which was about the time that Australia started to use the alternative wording. See also the previous note for some extensions of United Kingdom-Japan (1962) to other countries.

44. This wording avoids dealing with the theoretical situation dealt with by the Commentary's wording of a resident of neither state with a permanent establishment outside both states.

45. This expression suffers from the same defect as applies to the Commentary's alternative wording, that part of the definition of permanent establishment is restricted to a permanent establishment situated in a Contracting State, see text at note 40.

46. Japan uses the place of use as the source of interest paid in its internal law, which will be in state P^S when the borrowing is by the permanent establishment.

47. See text at note 8.

48. In addition to having a Japanese source, generally speaking the payment must be made in Japan for withholding tax to be charged, although a payment made outside Japan to a foreign entertainer is also liable to withholding tax. However, a payment made outside Japan by a Japanese corporation which has an office in Japan is deemed to have been made in Japan (Art. 212(2) of the Income Tax Law). A typical case of this is where an overseas branch of a Japanese corporation makes a payment to a foreign corporation outside Japan.

49. See *supra* note 26.

The United States started to use the alternative wording of the Commentary just as the United Kingdom and Japan were discontinuing its use. It was used in twelve US treaties between 1970 and 1984,⁵⁰ in addition to the treaty with Australia, which always uses it,⁵¹ but the United States stopped using the alternative wording in the early 1980s, and it was not contained in the US Models of 1981 or 1996. Unlike the United Kingdom and Japan, the United States does charge tax when it is the residence state of the payer, even when the interest is paid by the payer's permanent establishment outside the United States (except for interest paid by a financial institution), and so, unlike those two countries, it was giving up tax by adopting the alternative wording. A reason for the alternative wording is given in the Technical Explanation to the United States-Canada treaty (1980),⁵² which has also been approved by Canada.⁵³ This paraphrases the article and states that "Canadian tax will not be imposed on interest paid to a US resident by a company resident in Canada if the indebtedness is incurred in connection with, and the interest is borne by, a permanent establishment of the company situated in a third state." This result applies in any event under Canadian internal law so long as the parties are at arm's length and the interest is not paid in Canadian dollars. The provision has more effect in the United States which is prevented, as the residence state of the payer, from charging tax which it would otherwise do under internal law, if the countries in the quotation were reversed. A similar provision is also found in the royalties article of that treaty with a variation that if the source would be moved out of the Contracting States to a permanent establishment in a third country, it can be moved back again if the royalties are paid for the use of (or the right to use) intangible property or tangible personal property in one of the states.⁵⁴ This corresponds with the position under US internal law.⁵⁵

Australia is the only country represented that currently adopts the Commentary's alternative wording in its treaties. Australian treaties made since 1969 almost always⁵⁶ adopt the alternative wording or similar wording,⁵⁷ which moves the source of interest to the permanent establishment in the third state. In doing so, Australia aligns the treaty with its internal law, which treats the permanent establishment as the source of the interest.⁵⁸ Accordingly Australia does not give up any taxing rights but merely prevents taxation arising from the fact that the treaty can impose tax because the treaty source rules apply for the purpose of internal law.⁵⁹ Indeed, in cases where Australia follows Article 11(5) of the Model rather than the Commentary's alternative wording, the legislation bringing the treaty into effect in internal law, the International Tax Agreements Act, prevents a charge to tax on interest if Australia is the payer's residence state and the permanent establishment is elsewhere.⁶⁰

Some US treaties made in the 1970s and early 1980s⁶¹ and Australian treaties made since 1976⁶² have avoided the problem arising in the Model's definition of permanent establishment, which does not in terms apply to a permanent establishment in a third state by adding the following at the end of the definition of permanent establishment:

The principles set forth in the preceding paragraphs of this Article shall be applied in determining for the purposes of

paragraph 5 of Article 11 and paragraph 5 of Article 12 whether there is a permanent establishment outside both Contracting States, and whether an enterprise, not being an enterprise of a Contracting State, has a permanent establishment in a Contracting State.⁶³

By adopting the Commentary's alternative wording in Article 11(5), Australia avoids the problem which arises in Japan⁶⁴ and might also arise in France⁶⁵ of the Model creating double taxation by moving the source of the interest into the residence state of the payer when internal law determines it to be in the permanent establishment state. The French tax authority has not reached a final decision on this point.

It seems to us that the alternative wording given by the Commentary provides the best solution, although it could be improved by a variation to the effect that the payer's residence state only gives up its right to tax if the permanent establishment state exercises its right to tax the

50. US treaties with: Belgium (1970), Canada (1980), Cyprus (1984), Iceland (1975), Japan (1971), Korea (1976), Morocco (1977), Norway (1971), Philippines (1976), Poland (1974), Romania (1973), Trinidad and Tobago (1970). Some other treaties in this period did not include this wording: Bangladesh (1980), Denmark (1980), Egypt (1980), Finland (1970), Italy (1984), Malta (1980), New Zealand (1982), United Kingdom (1975), USSR (1973). The ending of the use of this provision may be connected with the adoption of the portfolio interest rules in 1984.

51. See next paragraph

52. Unlike the wording in the Commentary, the wording in this treaty is expressed to apply "for the purposes of this [the interest] article." However, its effect must consequentially apply for the purpose of Art. 21.

53. Canadian Department of Finance News Release No. 84-128, 16 August 1984 in relation to the treaty, and News Release 95-048, 13 June 1995 in relation to the 1995 Protocol

54. This was amended in the 1995 Protocol.

55. IRC § 861(a)(4)

56. Of 29 Australian treaties made since 1969, only those with China (1981) and Poland (1991) do not contain this provision. It is understood that Australia was following the US practice in adopting this provision; Australia-United States (1982) was in negotiation throughout the 1970s.

57. The Commentary's wording is used only in the Australian treaties with Canada (1980), France (1976) and Germany (1972). Normally Australian treaties read: "... has in one of the Contracting States or outside both Contracting States a permanent establishment." which has the same effect. See the next paragraph of the text in relation to the definition of a permanent establishment in a third state

58. Unless secured by mortgage of any property in Australia, except for interest paid outside Australia to a non-resident on debentures issued outside Australia: ITAA s. 25(2). The treaty would override this source rule.

59. See text at note 9

60. Although not liable to withholding tax, it is still possible for the interest to be taxed by assessment because the source rules for taxation by assessment are different from the withholding tax source rules. For an example of a provision preventing a charge to tax in this situation, see International Tax Agreements Act, s. 11ZA(2) in relation to Australia-Poland (1991), which states: "The provisions of the Polish agreement do not have the effect of subjecting to Australian tax any interest or royalties paid by a resident of Australia to a resident of Poland that, apart from that agreement, would not be subject to Australian tax." Similar wording is used in s. 11S(3) in relation to Australia-China (1988).

61. US treaties with: Australia (1982), Belgium (1970), Cyprus (1984), Egypt (1980), Iceland (1975), Israel (1975), Korea (1976), Norway (1971), Philippines (1976), Romania (1973). The list is not the same as the US treaties listed in note 50 containing the Commentary's alternative wording for Art. 11(5). This provision was not contained in the US Models of 1981 or 1996

62. The first use of this provision was in Australia-Netherlands (1976). It is understood that Australia followed the US practice as Australia-US (1982) was being negotiated throughout the 1970s.

63. Australia-New Zealand (1995).

64. See text at note 48.

65. The source of interest under internal law is in state P^s and not state S when the interest has a clear economic link with the permanent establishment.

interest, because otherwise the source state gives up its right to tax in favour of the residence state, which would not have to credit any source tax imposed by either the payer's residence state or the permanent establishment state.⁶⁶ This solution could be limited to cases where there are treaties between all three states in order to prevent the problem of permanent establishments in tax havens imposing a small charge to tax. Possibly there could also be a requirement that the permanent establishment state must charge not substantially less than the rate of tax which the payer's residence state would have charged. The alternative wording should also deal with the definition of permanent establishment as it applies to a third state.⁶⁷

2. Deductibility of the interest paid by a permanent establishment

It is interesting that the source provisions of the Model do not correspond to the non-discrimination provisions dealing with the deductibility of the interest. This demonstrates the difficulty of the Model in dealing with triangular situations. The P^S-R treaty provides for the source of interest to be in state P^S but that treaty says nothing directly⁶⁸ about deductibility. The S-R treaty provides both for source of the interest in state S, and deductibility by state S of interest paid to a resident of state R on the same basis as interest paid to a resident of state S,⁶⁹ which will be relevant only if S is a tax credit state which also taxes the profits of the permanent establishment in P^R and S⁷⁰ paying the interest. The S-P^S treaty does not, we have argued, have any effect on the source of the interest, but does provide that the taxation of the permanent establishment in P^S of a resident of S, which includes the deductibility of the interest, must not be less favourable than that applicable to a resident of state P^S (and a resident of that state has, under the P^S-R treaty, the right to deduct interest paid to a resident of state R in the same way as interest paid to its own residents).⁷⁰ The non-discrimination provision of the S-P^S treaty is not affected by Article 1,⁷¹ as it was in relation to the source of interest paid by the permanent establishment on the grounds that neither state was the residence state of the recipient of the interest,⁷² since the recipient of the net income of the permanent establishment, of which the deduction of interest paid is one element, is a resident of S. At least under the non-discrimination provisions, if there are treaties between all three states, deductibility is fully covered.

3. Four states involved

The situation can become more complicated than the triangular one we have been discussing since four states can be involved if the interest paid by the permanent establishment of the resident of state S in P^S to a resident of state R is attributable to its permanent establishment in a fourth state, P^R, which is a quadrilateral problem. Where the recipient's residence state R is an exemption state it will exempt the state P^R income from tax and will not be able to give credit for the state S tax because there will be no tax in state R against which to credit it.⁷³ Where R is a tax credit state it will credit both the S, P^S and P^R tax on the interest, although not all states tax foreign income arising to the permanent establishment when they are state P^R.⁷⁴ The tax in state P^R may or may not have been reduced by a

credit for the S tax. The issue of a permanent establishment state giving credit for source state tax is discussed in the OECD Triangular Cases Report.⁷⁵ Under the R-P^R treaty, the non-discrimination article may require state P^R to give credit for state S taxes, but not all states agree with

66. Compare the Japanese provision dealing with the opposite situation of taxing third state income attributable to a permanent establishment in Japan if the source state does not tax it, see *infra* note 74.

67. See text at note 40.

68. But see text at note 70.

69. Art 24(4).

70. Art 24(3).

71. See text at note 31. Art 1 is overridden in relation to discrimination only on the ground of nationality by Art. 24(1).

72. See text at note 31.

73. See the OECD Triangular Cases Report (*supra* note 18) para. 36, and, for a table demonstrating the effect, see Kees van Raad, "Triangular Cases", 33 *European Taxation* 9 (1993), at 298. This point is not accepted by some commentators in the Netherlands who argue that the credit under the S-R treaty and the exemption under the P^R-R treaty are two separate claims to relief, so that credit has to be given, effectively against tax on other income, by R even though the profits in P^R are exempt. Some source states are concerned that they will have to reduce their tax by treaty when the permanent establishment state does not charge tax and the residence state exempts the profits of the permanent establishment. Some recent US treaties require a minimum tax charge in these circumstances, for example 60% of the tax which would have been imposed if the income had not been attributable to a permanent establishment outside the state, see Netherlands-United States (1992 in the 1993 Protocol), France-United States (1994), Luxembourg-United States (1996), Switzerland-United States (1996), Ireland-United States (1997) and South Africa-United States (1997). A similar provision is also contained in Canada-France (1975 in the 1995 Protocol). These provisions suffer from the same problem as the Commentary's alternative wording for Art. 11(5) that part of the definition of permanent establishment is restricted to a permanent establishment situated in a Contracting State, see text at note 40.

74. States which do not tax the foreign income of a permanent establishment in their state include: France (except for dividends and interest) and, subject to an exception, Japan. The Japanese exception is that if a financial transaction, such as money lending and investment, is conducted through a Japanese fixed place of business of a foreign legal entity in a foreign country which does not impose tax, the income from such financial transaction is deemed to have a Japanese source (Art 176(5) of the Corporation Tax Law Enforcement Order, Art 279(5) of the Income Tax Law Enforcement Order). In Australia, in the absence of a treaty source rule, which exists in most treaties, the position is unclear; there is no constitutional reason for the International Tax Agreements Act not increasing tax under domestic law, but there are arguments that the Act does not have this effect. Other states represented by the authors do tax third state income attributable to a permanent establishment in their country. In the Netherlands third state source income attributable to a permanent establishment in state P of a Netherlands resident is exempt; in the opposite case of third state income attributable to the permanent establishment in the Netherlands of a resident of state P, one might expect that the income would be exempt. The present position of the Ministry of Finance is not known but in the past they have contended that the third state income was taxable; the issue has not been tested in court. There is no Canadian case, but if the interest is considered to be income "from businesses carried on in Canada", Canada will impose tax: ITA s 115(1)(a)(iii). Italy has stated in the decree of 16 March 1993, No. 136, implementing the EC Parent-Subsidiary Directive, that the directive is applicable to Italian permanent establishments of EC companies, thus implying that foreign dividends of such a permanent establishment are taxable subject to an exemption for 95%. Foreign-source income of a permanent establishment is liable to corporation tax, but not income tax, in the United Kingdom, see TA 1988, s. 70(3).

75. See *supra* note 18.

this interpretation,⁷⁶ or give such credit in practice because of problems of internal law,⁷⁷ although the Commentary states that a majority of OECD member states do give credit in these circumstances.⁷⁸ The Commentary⁷⁹ puts forward an additional sentence to be added to the permanent establishment non-discrimination provision in the R-P^R treaty to provide for relief in such circumstances, requiring state P^R to give relief for the lesser of the rate of tax permitted under the S-R treaty (being the tax actually charged) and the rate which would have applied if the S-P^R treaty had been applicable.⁸⁰ This addition would presumably also cover tax paid in P^S with the substitution of the P^S-P^R for the S-P^R treaty, since it refers to interest "from" a third state, which would include P^S, although the discussion in the Report and the Commentary which is derived from it deals with interest arising in state S. In Belgium and Canada, the problem of triple source exacerbates the difficulty that, under internal law, credit for foreign taxes on interest in Belgium, and non-business income in Canada, is limited to 15%.⁸¹

B. Article 10(5) of the Model

Article 10(5) of the Model contains what might be described as a negative source rule, stating that dividends do not have a source in the state in which the profits out of which the dividends are paid are derived, as follows:⁸²

Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other state.

Unlike Article 7 which deals with taxation of the profits of a company earned in the other state, this provision deals with taxation of the shareholders, at least so far as dividends are concerned.⁸³ Some states, for example the United States, regard dividends paid out of profits arising in the United States as having a source there in some circumstances and apply a withholding tax under internal law.⁸⁴ This taxation is prevented by the treaty provision. It is, however, odd that no relationship is required between the dividends and the profits derived from the other state which makes application of the provision difficult if the taxation in the source state is for another reason, such as dual residence. If the company resident in state S, derives income from a permanent establishment in state P^S and pays dividends to a recipient in state R, this provision in the S-P^S treaty prevents state P^S from taxing the dividends (or the undistributed profits). If there is a P^S-R treaty, taxation of the dividends by state P^S is prohibited anyway by Article 21, except where the taxpayer is a dual resident of S and P^S.

Article 10(5) is an interesting contrast to Article 11(5), applying to interest, where we argued that the S-P^S treaty had no effect to determine the source of interest because

Article 1 was not satisfied since neither state was the residence state of the recipient of the interest. Here there is an

76. See the OECD Triangular Cases Report (*supra* note 18) para. 19. The countries named are: Ireland, Switzerland (which gives credit only by treaty and then only to residents) and the United Kingdom (although the court in *Sun Life Assurance of Canada v Pearson* [1984] STC 461 considered that credit should be given under the treaty, but decided that this was prevented by the way the treaty was brought into force in internal law, so the United Kingdom might better be included in the following note as a country having problems of internal law). The United Kingdom does give credit to a permanent establishment of a bank for tax on interest: TA 1988, s. 794(2)(c), and of an insurance company for tax on income or gains: s. 794(2)(d) (see Sched. 19AC, para. 13). Australia does not include the non-discrimination article in its treaties. The only relief given to non-residents is a deduction for foreign taxes on income attributable to branches of foreign banks.

77. See "The Non-Discrimination Article in Tax Treaties" [1991] *BTR* 359 and 421, at 433-6. In addition to those countries in the previous note, countries which do not give credit in these circumstances include Canada in its internal law (except in the very narrow case of property held by a former Canadian resident which he elects to treat as "taxable Canadian property" when he becomes a non-resident of Canada), the Netherlands and Italy (if foreign income is given a domestic source for taxing the permanent establishment). In Canada-United States (1980) the permanent establishment non-discrimination provision is expressed to apply notwithstanding the double taxation relief article, making it clear that credit is available to a permanent establishment, as is confirmed by the US Technical Explanation. It is not known whether this addition is regarded as clarification or whether no credit applies under other treaties not containing this additional wording. Within the European Union, credit may be available to a permanent establishment in accordance with the principles of the French *Avoir Fiscal* case, Case 270/83, *EC Commission v France* [1986] ECR 273.

78. Art. 24 Comm para. 52. Credit may also be required under the EC Treaty, see the French *Avoir Fiscal* case, Case 270/83, *EC Commission v France* [1986] ECR 273.

79. Art. 24 Comm para. 52, proposing an addition to Art. 24(4). There is a different provision in the France-Italy treaty (1989) also providing for credit in these circumstances, which is referred to in para. 45 of the OECD Triangular Cases Report (see *supra* note 18). This treats the permanent establishment as if it were a resident so that the reduced rate of withholding tax is charged, and credit is given, under the S-P^R treaty (see, in France, Instruction 14B 1-94 of 26 March 1994). There is nothing to prevent the S-R treaty from also applying. Para. 46 of the Report states that a large majority of the OECD member countries are opposed to this solution because it departs too much from the principles underlying the Model and current practices, presumably because it treats a permanent establishment in the same way as a resident, and is contrary to Art. 1. The Commentary does suggest treating the permanent establishment as if it were a resident in the case where the source and residence states are the same state and the income is paid to a permanent establishment in the other state, in order to allow the source (and residence) state to impose the treaty rate of withholding tax which is prevented by arts. 7 and 23A, when the residence state is an exemption state: Art. 21 Comm para. 5 and Art. 23 Comm para. 9.

80. The drafting of the provision is defective as it states that the credit is not to exceed the tax under the S-R treaty, whereas according to the explanation in the Commentary it should say the S-P^R treaty.

81. In Canada the excess tax can be deducted from the income.

82. Art. 10 Comm para. 37 makes the point that the paragraph is confined to taxation at source. Note the unusual provision, which is combined with Art. 10(5), in Malaysia-Singapore (1968) according to which, for the purpose of the dividend article only, a resident of one of the states may declare itself to be a resident of the other.

83. The prohibition on the taxation of undistributed profits naturally applies to the taxation of the company, see Art. 10 Comm para. 37 (introduced in 1992).

84. This provision does not apply if the foreign corporation is subject to the branch tax, but branch tax may not apply because of treaty exemptions or pre-1987 earnings, IRC § 884(e)(3). See the US reservation in the 1977 Model Art. 10 Comm para. 85 under which the United States reserved the right to impose dividend withholding tax on dividends paid by a non-US company if at least one-half of the company's income consists of profits attributable to a permanent establishment in the United States. The threshold has been reduced to 25%, IRC § 861(a)(2)(B). Presumably because of the branch tax this right to tax dividends paid out of permanent establishment profits is not contained in the 1996 US Model. A provision reserving the right to tax in accordance with this reservation is included in the US treaties with: Argentina (1981), Aruba (1986), Australia (1982), Barbados (1984), Hungary (1979), Malta (1980), Netherlands Antilles (1986), New Zealand (1982), Tunisia (1985).

implied exception to Article 1 because the provision by its terms envisages dividends being paid to third states: "...may not impose any tax on the dividends paid by the company...". It might be better if the point was put beyond doubt in the OECD Model by making an express exception to Article 1.⁸⁵ Some countries' treaties contain even clearer implied exceptions to Article 1 by referring specifically to dividends paid to third country residents:

Australia Dividends paid by a company which is a resident of a Contracting State, being dividends to which a person who is not a resident of the other Contracting State is beneficially entitled, shall be exempt from tax in that other State except in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base situated in that other State. This paragraph shall not apply in relation to dividends paid by any company which is a resident of Australia for the purposes of Australian tax and which is also a resident of Vietnam for the purposes of Vietnamese tax.⁸⁶

United States A Contracting State may not impose any tax on dividends paid by a resident of the other State, except insofar as the dividends are paid to a resident of the first-mentioned State or the dividends are attributable to a permanent establishment or a fixed base situated in that State....⁸⁷

While dealing satisfactorily with taxation of dividends based on source, which we have equated with any charge not based on residence, a problem with Article 10(5) is that it is unclear whether it prevents taxation of dividends paid by a company for other reasons, such as by the losing state under a dual residence article.⁸⁸ The opening words of Article 10(5) dealing with source suggest that it does not prevent such taxation,⁸⁹ but it is an odd result to prevent taxation if there is a source of income in the other state but to permit it where there is not, and it is possible that the draftsmen of the Model did not contemplate that there could be taxation on a basis other than source in the state of non-treaty residence. There are decisions in the Netherlands⁹⁰ and Canada⁹¹ to the effect that the Model does prevent this type of taxation, although in the Canadian case the company had income with a source in Canada as well. The 1996 US Model quoted above is more satisfactory as it prevents the imposition of tax on dividends paid by a company resident in the other state on any grounds, thereby preventing taxation by the losing state in a dual residence case. Australian treaties, on the other hand, preserve the charge to tax on dividends paid by a company by the losing state in a dual residence case in the last sentence quoted above. As it is not directly related to source we shall not discuss this point further other than to suggest that the OECD should clarify the Model.

Article 10(5) also prevents the source state from taxing undistributed profits of a company resident in the other state. The United States has made a reservation⁹² preserving its right to impose its accumulated earnings tax and

personal holding company tax in order to prevent tax avoidance, which are presumably the type of taxes to which this provision is intended to apply.⁹³ The 1996 US Model now prevents any such taxation except for the branch tax, and except when taxing its own residents. The Commentary states that this provision does not prevent taxation by the shareholder's residence state of undistributed profits under controlled foreign companies legislation as such taxation is not imposed because a company

85. As is the case in Art. 24(1) last sentence

86. Australia-Vietnam (1992). See also, for example, Australian treaties with: Fiji (1990), India (1991), Indonesia (1992), Kiribati (1991).

87. 1996 US Model Art. 10(7). This is different from the 1981 US Model which prevented a state taxing dividends paid by a non-resident company unless paid to a resident of, or a permanent establishment or fixed base in, that state or was paid out of profits of a permanent establishment in that state where the income attributable to the permanent establishment was at least 50% of the company's total income. This prevents taxation of dividends of a third state resident company but such taxation is already prohibited by Art. 21.

88. In the 1977 Model, the United States had made a reservation (Art. 10 Comm para. 83), which is not included in the current version of the Model, saying that the text should clarify that the prohibition of para. 5 will apply regardless of whether the company derives profits or income from the other Contracting State.

89. This interpretation is more consistent with the Commentary's statement that the article does not prevent taxation of dividends which are cashed in a state because the criterion for taxation is the payment of the dividend and not the origin of the profits out of which the dividend was paid. Art. 10 Comm para. 35. This occurs in Belgium, Art. 227(2) ITC, although it would be prevented if the recipient of the dividends is resident in a treaty state (Official Commentary on Tax Treaties 10/512-514), as stated in Art. 10 Comm para. 35.

90. This Supreme Court case on the Netherlands-Ireland treaty (1969) concerned a dividend paid to a resident of the United States by a Netherlands incorporated company which was managed and controlled in Ireland, which according to the treaty was an Irish resident (2 September 1992, No. 27 252 published in BNB 1992/379). For comments on this decision, see Pieter M. Smit, "Taxation of Dividends Distributed by a Dual Resident Company", 33 *European Taxation* 1 (1993), at 36 and Kees van Raad, "Triangular Cases", 33 *European Taxation* 9 (1993), at 298. The Netherlands tax authority contended that Dutch withholding tax was payable on the dividend on the basis that, since the company did not derive any income from the Netherlands, the equivalent to Art. 10(5) of the Model did not prevent the Netherlands from taxing under its internal law. Art. 21 was not relevant as the income was payable to a resident of a third state, the United States. The Supreme Court, relying on language in the OECD Commentary that this provision aims at eliminating extraterritorial taxation, held that the prohibition on taxing the dividend applied "even if" (see the last phrase of Art. 10(5)) the dividend was paid out of Netherlands-source income, and so there was even less right for the Netherlands to tax the dividend if it was not paid out of Netherlands-source income.

91. *Hunter Douglas Ltd v. The Queen* [1979] CTC 424, 79 DTC 5340, also in relation to a dual resident company having its treaty residence in the Netherlands under the former Canada-Netherlands treaty (1957). The wording of the Canada-Netherlands treaty was different from the Model stating that tax should not be imposed by reason of the fact that the dividends were paid out of profits derived from the other state, but the Revenue admitted there was no difference in meaning between that wording and the OECD Model wording. The company did have accumulated profits earned in Canada and the court relied on expert evidence (this was before the Netherlands case) that in the converse case the Netherlands would not impose tax on a dividend paid to a third state resident. Ironically, the expert evidence was based on a statement given by an official of the Netherlands Ministry of Finance, which some years later took the opposite position in a case in which Netherlands revenue was at stake (see the case referred to *supra* in note 90).

92. Art. 10 Comm para. 86.

93. The only US treaties containing the prohibition on taxing undistributed income are those with: Canada (1980), China (1984), France (1994), India (1989), Italy (1984), the Netherlands (1992).

resident in one state derives profits from the other, even though that may sometimes happen to be the case.⁹⁴

III. SOURCE IN RELATION TO DOUBLE TAXATION RELIEF

The Model provides for double taxation relief to be given for income which may be taxed in the source state in accordance with the provisions of the Convention, thus ensuring that the treaty taxing and relieving provisions correspond.⁹⁵ We have previously equated what a state is entitled to tax in the hands of a resident of the other treaty state with income having its source in the taxing state. The Model therefore effectively states that the residence state must give relief for tax on income which has a source in the other state. This normally⁹⁶ eliminates any consideration of source within the meaning of the residence state's law and any potential conflict between this and the treaty. An example is given in the Commentary⁹⁷ of a resident of State R with a permanent establishment in State E to which is attributable business income arising in State R. State R must give relief for tax on the income attributable to the permanent establishment even though it arises in its own state.⁹⁸ It is therefore unnecessary to mention source in the double taxation relief article. Despite this, reference to source in the relief article is extremely common and occurs in treaties entered into by Australia, Belgium, Canada, France, Germany (for exemption), the United Kingdom and possibly Japan,⁹⁹ among the countries represented by the authors. It is necessary, however, to refer to source in a relief article where the treaty gives relief in accordance with internal law relief rules, which occurs in Australia, Belgium, Canada, Germany (for credit), Japan, the United Kingdom and the United States, if those rules contain a requirement that the income has a source in the taxing state, which is the case in the common law states. In cases where there is a specific requirement for source to be in the treaty partner state for relief to be given, it is necessary to deal with the potential conflict between internal law and the treaty source rules.

A. Switzerland, the Netherlands and Italy: no source issues arise

We can eliminate from further consideration Switzerland and the Netherlands, as neither refers to source in their treaty relief articles¹⁰⁰ nor has internal law relief rules dealing with source to which treaties could refer.¹⁰¹ Source can never be a problem in giving relief in such countries.¹⁰² Italy does not refer to source in its treaty relief articles¹⁰³ and so, even though foreign source is a requirement for giving relief under internal law,¹⁰⁴ it is not a requirement for treaty relief;¹⁰⁵ again source will not create any problems in giving relief.

B. Reference to internal law by the common law states

The possibility of conflict between internal law and treaty source rules arises when a state requires source in the other state as a condition of granting relief and also refers in its

treaties to internal law rules for giving relief. This occurs in the common law states:

Australia Subject to the provisions of *the law of Australia from time to time in force*

94. See Art. 10 Comm para. 37 (introduced in 1992). The Commentary also makes the point that, in relation to undistributed profits, the paragraph is concerned only with taxation of the company and not the shareholder. For a case on the interaction of the UK-controlled foreign companies legislation and tax treaties, where the Netherlands subsidiary of a UK company derived interest from the United Kingdom, see *Bricom Holdings Ltd v. IRC*. [1997] STC 1179, CA. The decision that the treaty did not prevent the charge under the CFC legislation was based on internal law and this provision did not form part of the reasoning. Daniel Sandler, in *Pushing the Boundaries*, Institute for Fiscal Studies, 1994, at 106, suggests that the provision appears directly to contradict the UK-controlled foreign companies legislation (and see the discussion at 72). There are conflicting French decisions on whether a tax treaty prevents the charge under the French CFC legislation, the Lower Administrative Court of Strasbourg deciding on 12 December 1996 that it did, and the Lower Administrative Court of Paris deciding on 21 November 1995 that it did not, neither decision being based on this provision (an English translation is given in (1997/98) 1 OFLR 22 and 27). Canada always preserves in its treaties the right to charge tax under its FAPI rules.

95. Art. 23. For a discussion of the issue where the two states take a different view of the categorization of the income, see "Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization", 36 *European Taxation* 4 (1996), at 118 et seq. and [1996] BTR 212.

96. An example of when the problem can still arise is when the residence and permanent establishment states do not agree that income arising in the residence state is attributable to the permanent establishment in the case described in the next sentence.

97. Art. 23 Comm para. 9.

98. The Commentary points out that under Arts. 7 and 23A where the source and residence states are the same and the income is attributable to a permanent establishment in the other state, only the permanent establishment state may tax the income if the residence state is an exemption state. It puts forward an alternative that for dividends, interest or royalties, the two states should agree on the source state levying a withholding tax at the treaty rate (Art. 21 Comm para. 5), and the permanent establishment state giving credit for such source state tax (Art. 23 Comm para. 9).

99. There are examples in older Japanese treaties which require a source in the other state as a condition for relief (e.g. Japan-United States (1971)) but none in the post-1980 treaties, see *supra* note 9. Although Japanese treaties, such as the example at *infra* note 142, use the expression "derives income from [the treaty partner]" this may not be considered by Japan to be a reference to source.

100. Former Netherlands-United States (1948) was an exception in requiring source in the other state. In a case involving this treaty, in which a Netherlands resident with income from employment exercised in the United States, the court held that exemption applied since the income was taxable in the United States although no actual tax was paid because of the deduction of alimony: *Gerechthof Amsterdam*, 7 March 1986 No. 2212/85, BNB 1987/185. This was in accordance with the position under internal law and the treaty did not impose a further condition that tax should actually be paid. Compare the similar argument in relation to some German treaties in the text at note 151.

101. Switzerland does have internal law credit rules but these apply only where a treaty provides for credit. The Netherlands has computational rules in internal law relating to exemption and credit to which its post-1985 treaties typically refer.

102. So long as the relief article follows the Model in requiring relief to be given for income which may be taxed in the other state in accordance with the treaty. If the treaty does not contain an "Other Income" article, the source state may tax an item of income under internal law which the treaty article will not relieve as it will refer only to income permitted by the treaty to be taxed, for example a type of income not covered by the treaty.

103. Nor does the treaty refer to internal law rules.

104. There are no internal law source rules applicable to relief. The only source rules in internal law are for the purpose of taxation and relate to immovable property (Art. 84(2) of the Income Tax Code), and impliedly dependent services income (Art. 3(3)(c)), which exempts certain income from employment exercised in the other state; this will be repealed with effect from 1 January 2001).

105. Except for the treaty with the United States (1984) and the now superseded treaty with the USSR (1985), Italian treaties do not, as does the Model, expressly require taxation in the other state to be in accordance with the provisions of the treaty but this must be implied in giving credit for tax on income which may be taxed in the other state.

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, whether directly or by deduction, in respect of income derived by a person who is a resident of Australia from sources in Canada ... shall be allowed as a credit against Australian tax payable in respect of that income.¹⁰⁶

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 ... 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; ...¹⁰⁷

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) [] 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 [] ... 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...¹⁰⁸

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 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 the appropriate amount of income tax paid or accrued to the Netherlands by or on behalf of such resident or national...¹⁰⁹

All these treaty provisions make reference to internal law credit provisions which give credit for tax only on income with a foreign source,¹¹⁰ and all these treaty provisions, except the United States¹¹¹ one, specifically refer to income from sources in the other state. In these cases, in the absence of any definition of source in the treaty, the residence state when granting credit or exemption will use its own meaning of source as part of the reference to internal law relief rules.¹¹² This can give rise to conflicts where the

treaty partner state taxes the income in a way which is permitted by the treaty, but the residence state considers that the source was in the residence state (or even in a third state).¹¹³ This problem led to the common law countries including treaty relief provisions specifying the source of all types of income. These provisions give the source of the income as the treaty partner state when that state has a right of taxation under the treaty. They evolved gradually. Originally the source of some doubtful items of income was defined, such as personal service income¹¹⁴ and income from employment on board ships or aircraft.¹¹⁵ These articles tended to become more complicated and ultimately a number of Australian¹¹⁶ and United States¹¹⁷ treaties contained rules dealing with the source of up to eight types of income, with a final paragraph in US treaties stating that the source of other types of income was to be determined in accordance with each state's law. From about 1967¹¹⁸ the United Kingdom, and from the

106. Australia–Canada (1980). This is standard wording in Australian treaties.

107. Canada–Netherlands (1986). This is standard wording in Canadian treaties.

108. This is standard wording in UK treaties.

109. US–Netherlands (1992).

110. Australia ITAA ss. 6AB and 23AH(12) (defining “foreign income” for the purpose of the credit (s. 160AF(1)) and exemption provisions (s. 23AH), respectively); Canada ITA ss. 4 and 126 (Canada uses a source concept to provide foreign tax credits in relation to property income and a separate calculation of business income in each foreign country in which business is carried on to deal with foreign tax credits on business income); United Kingdom TA 1988, s. 790(4) (a unilateral relief rule, but applying for treaty purposes by virtue of s. 788(3) giving effect to treaties subject to the provisions of Part XVIII containing this provision); US IRC § 861, § 862 and § 863.

111. This exclusion makes no difference because US internal law does require source in the other state before giving relief, see text at note 135.

112. Alternatively, it could be argued that source is an undefined term which, in accordance with Art. 3(2) of the Model, is to be defined in accordance with the residence state's law.

113. This arises regardless of differing views about the categorization of the income. For a UK example, not concerning a treaty, see *Yates v. GCA International Ltd* [1991] STC 157 in which Venezuela taxed the whole profits of the UK resident taxpayer in respect of work carried out partly in the United Kingdom and partly in Venezuela. The United Kingdom gave credit only for the part referable to work carried out in Venezuela, which under UK law, was the only income having a source in Venezuela.

114. In the United Kingdom this was a difficult area of case law before a statutory rule was made in 1956 defining the source of employment income in the United Kingdom. In order to prevent this difficulty the source of such income was defined in United Kingdom–United States (1945). Other countries had the same difficulty over the source of employment income.

115. E.g. Canada–Ireland (1966), Canada–Trinidad and Tobago (1966)

116. Australian treaties with: United Kingdom (1967), former Singapore (1969), dealing with eight types of income.

117. Brazil (1967, never ratified), Cyprus (1984, never ratified), Egypt (1980), Iceland (1975), Indonesia (1988) (a very late example), Israel (1975), Japan (1971), Korea (1976), Norway (1980), Philippines (1976)

118. The first examples were Luxembourg–United Kingdom (May 1967) (containing slightly different wording from the normal provision quoted below: “Income which under the Convention may be taxed in Luxembourg shall be deemed to be income from sources in Luxembourg”) and Netherlands–United Kingdom (October 1967). Early examples of this wording, as in these two treaties, were generally limited to determining the source of income in the other state for the purpose of UK credit, but from Austria–United Kingdom (1969) the provision was usually reciprocal. Belgium–United Kingdom (1987), containing the same rule as the former treaty, is the only modern treaty in which the source of income is defined only for personal service income and income from employment on ships and aircraft.

mid-1970s the United States,¹¹⁹ Canada,¹²⁰ and Australia¹²¹ (the common law countries) have in their treaties all varied their internal source rules by providing that income has a source in the other country if it is taxable there in accordance with the treaty, for the purposes of determining whether the residence state gives credit for the source state tax or exemption. This type of source rule has been used in nearly all treaties, often applying to the other state as well. Recently the United States has, however, moved away from using this source rule and it is no longer to be found in its Model treaty; the current US position is considered below.¹²² The following are examples of references to source in common law countries' current treaties, or, in the case of the United States, earlier treaties:

Australia Income, profits or gains derived by a resident of a Contracting State which, under any one or more of Articles 6 to 8 and 10 to 19 and 21, may be taxed in the other Contracting State, shall for the purposes of Article 23 and of the law of the first-mentioned Contracting State¹²³ relating to its tax be deemed to be income from sources in that other Contracting State.¹²⁴

United Kingdom For the purposes of the preceding paragraphs of this Article [the double taxation relief article], profits income and capital gains owned by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources in that other Contracting State.

United States For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise exclusively as follows:

- (a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 2 of Article 1 (General scope) shall be deemed to arise in that other State;
- (b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.¹²⁵

These all provide that income which may be taxed in the other state in accordance with the treaty has a source there for the purpose of giving relief under the treaty. The Australian provision also applies the treaty source rule for internal law purposes because, although Australian treaties use the credit method of avoiding double taxation, internal law often uses the exemption method.¹²⁶ One of the internal law exemption provisions¹²⁷ requires the income to have a source outside Australia. It is therefore

important for the treaty source rule to apply for this internal law exemption as well, otherwise the income might have a domestic source in internal law, which might instead bring the treaty credit into effect.¹²⁸ Some UK treaties also contain a source rule providing that in transfer pricing cases the profits which should have been made in the other state have a source in the other state.¹²⁹

The version used by Canada set out below refers to income having a source in the other state if it is taxed, as opposed to being taxable, in the other state.

Canada For the purposes of this Article, profits, income or gains of a resident of a Contracting State shall be deemed to arise from sources in the other Contracting State if they are taxed in that other Contracting State in accordance with this Agreement.¹³⁰

119. The first use by the United States was in the UK treaty of 1975, although at the time other US treaties were made with source rules set out in a separate article (see *supra* note 117). It was used generally in US treaties from the 1980s.

120. Canadian treaties with: Belgium (1975), France (1975), Israel (1975), Morocco (1975). These were the first treaties signed by Canada after the 1972 tax reform which introduced capital gains tax applicable both to residents and non-residents of Canada which do not contain any concept of source. The adoption by Canada of a capital gains tax applicable to non-residents of Canada disposing of taxable Canadian property irrespective of any source of the capital gain might have influenced the adoption of this provision in Canadian treaties.

121. Australia-Netherlands (1976) in the Protocol.

122. See the heading *The new US position*.

123. On the other hand, the treaties with Italy (1982), Korea (1982), Malaysia (1980), Malta (1984), Philippines (1979), Switzerland (1980) and Thailand (1989) treat income of a resident of one state which under the treaty may be taxed in the other state as having a source in the other state for the purpose of the relief article and "of the income tax law of that other State" [i.e. the source state], which appears to refer to the law of the wrong state.

124. Australia-Vietnam (1992). In addition, the treaty contains the following provision dealing with the source of income for taxing purposes, which is similar to the provision in the text at note 9 but applies to both states: "Income, profits or gains derived by a resident of a Contracting State which, under any one or more of Articles 6 to 8 and 10 to 19 and 21, may be taxed in the other Contracting State, shall for the purposes of the law of that other Contracting State relating to its tax be deemed to be income from sources in that other Contracting State." This seems to be Australia's preferred wording and is also used in the treaties with: Fiji (1990), India (1991), Ireland (1983), Kiribati (1991), New Zealand (1995), Papua New Guinea (1996). Different wording is used in the treaties with: Hungary (1990), Indonesia (1992), Poland (1991), Spain (1992) but the effect is probably the same. In other cases the provision is applied to Australia only, see for example the treaties with: Austria (1986), Denmark (1981), Finland (1984), Norway (1982), Sri Lanka (1989), Sweden (1981), United States (1982). In the treaties with Canada (1980) and China (1988) the source rule applies for treaty relief only, see the text at note 128.

125. Former US Model (1981) Art. 23(3). The only treaty source rule contained in the 1996 US Model relates to the case of a US citizen resident in the treaty partner state.

126. ITAA, ss. 23AH and 23AJ.

127. *Id.*, s. 23AH.

128. This problem seems to arise with the treaties with Canada (1980) and China (1988), in which the source rule applies for treaty relief only.

129. This is found in about 21 treaties, of which the only ones since 1980 are: China (1984), Czechoslovakia (1990), Falkland Islands (1984), Gambia (1980), Indonesia (1993), Mauritius (1981), Tunisia (1982), Uganda (1992). The same is found in some earlier Australian treaties, e.g. Singapore (1969, removed by the 1989 protocol), Japan (1969), United Kingdom (1967).

130. Canada-Germany (1981). This wording is used in almost all modern Canadian treaties with the exception of the treaties with Australia (1980), Hungary (1992), United States (1980) and Iceland (1997), which define source in the other state if the income may be taxed in the other state (Canada-Switzerland (1997) uses taxed in relation to Canada and may be taxed in relation to Switzerland). The same requirement for tax to have been paid is found in a few other German treaties, see *infra* note 151, and in Australia-China (1988), alone among Australian treaties, perhaps because this treaty provides for credit in the case of both states.

The only difference this change makes in Canada is that it prevents income which is not taxed in the other state from being deemed to be income with a source in the other state for determining the per-country limitation on foreign tax credits. If the item of income, profits or gain is considered to have its source in the other state by Canada's internal law, the treaty does not, however, affect this. In the other country, relief will not be given if Canada does not actually tax the income.¹³¹

Thus, by a roundabout route, the result of including such treaty provisions is the same in the common law states as it is in other states that do not give relief by reference to internal law rules and adopt the wording of the relief article of the Model, namely that credit is given for tax on income which, in accordance with the provisions of the Convention, may be taxed¹³² in the source state. Since in common law states treaty credit is given in accordance with internal law rules, which do contain source rules, the treaty must also contain source rules which apply for treaty purposes instead of the internal law rules; these merely provide that income taxable in accordance with the treaty has a source in the taxing state. If the treaty had not referred to internal law rules the Model's wording would give exactly the same result, although it would be more difficult to fit the rules into internal law.

The new US position

As mentioned above, the United States used a treaty source rule similar to the other common law countries from about 1975 until the late 1980s.¹³³ While this source rule was used, the result was the same as in the other common law countries in spite of the fact that the treaty credit article in US treaties did not include a requirement for the source to be in the other state¹³⁴ because of the reference to internal law credit rules to which the treaty source rules will be applied.¹³⁵ An example of the effect of such a treaty source rule is seen in a ruling¹³⁶ concerning a US citizen working for a Japanese airline and performing some of his duties in the United States. The source of the income was in Japan under the treaty, as the residence of the operator of the airline, while under internal law the source was in the United States, as the place of performance of the duties. The ruling confirmed that the United States was obliged to give credit under the treaty.

The United States also varies its internal law source rules where it taxes its citizens resident in the other state under the saving clause in the treaty. The income may arise in the United States and qualify for reduced withholding tax; the other state will then tax the income with a credit for the US tax. When taxing its citizens the United States must give credit for the tax in the other state, even though the income had a US source. This provision is found in a number of modern treaties and is now contained in the US Model.¹³⁷

Having apparently solved the problems of determining source under internal law in all the common law countries it is surprising that the United States has reverted to the former position by no longer using a treaty source rule. The reason for some recent treaties¹³⁸ and the 1996 US Model treaty no longer containing the source rule adopted generally since 1975 and contained in the 1981 US Model, is not mentioned in the Technical Explanation to the new

US Model, but seems to be a requirement imposed by the Senate in approving treaties. The current US treaty policy seems to be to give some credit but not to be bound in advance to give credit for everything which the other state is permitted to tax under the treaty. The Mutual Agreement Procedure article in the 1996 US Model contains an addition to Article 25(3) that "In particular the competent authorities of the Contracting States may agree: ... (e) to the same application of source rules with respect to particular items of income."¹³⁹ If the US approach is to give relief for income taxed in the other state in accordance with the treaty only if the other state agrees to do the same, this is unlikely to give much scope for negotiation by the United States. Other states represented by the authors, with the exception of Germany, are always prepared to give relief for income taxed in the other state in accordance with the treaty, either because they regard source as irrelevant, or because expressly or impliedly they adopt the treaty source rules. Accordingly, in practice, they are likely to be willing to agree to a treaty source rule which results in relief being given if the United States is willing to agree the same. It is surprising that other states are prepared to make a treaty with the United States which does not oblige the United States to give relief for tax which the treaty entitles them to charge.

131. See *infra* note 151 in relation to the treaty with Germany and other German treaties containing this wording.

132. Or, normally in Canada, is taxed

133. See *infra* note 138.

134. See *supra* note 111.

135. Giving relief in all cases in which the other state is entitled to tax under the treaty is the result which the American Law Institute Federal Income Tax Project, International Aspects of US Income Taxation II, Proposals on US Tax Treaties, 1992, proposes at 235.

136. See Rev. Rul. 79-28, 79-1 CB 457, amplified by Rev. Rul. 79-206, 79-2 CB 279. The usual US saving clause, under which the United States can continue to tax its citizens and residents as if there were no treaty, excepted the credit article from its operation. This ruling is discussed by Pamela B. Gann, in "Tax Credit", 38 *Tax Law Review* 1 (1982), at 20.

137. Art. 23(3) of the 1996 US Model.

138. Indonesia-United States (1988) contains a source article defining the source of various types of income with unspecified types being dealt with under internal law but internal law source rules have precedence over the treaty rules. In Germany-United States (1989) income which is taxed in the other state in accordance with the treaty has a source there but this is subject to any US law limiting the credit in a way that prevents the crediting of foreign tax against US tax. The Technical Explanation provides that "Where, however, there is an inconsistency between Convention and Code source rules, the Code source rules (e.g. Code section 904(g)) will be used to determine the limits for the allowance of a credit under the Convention." In India-United States (1989) internal law source rules have precedence over the treaty rules, except for determining the source of royalties and services included in the royalties article. These treaties are criticized in the ALI report (see *infra* note 135), at 233-5. Switzerland-United States (1996) contains no treaty source rules but see the next note for the mutual agreement article providing for agreement on the same application of source rules with respect to particular items of income, and providing in default of agreement for binding arbitration if both the states and the taxpayer agree. On the other hand, two other recent US treaties, with Austria (1996) and Luxembourg (1996) do both contain treaty source rules similar to the one used previously (see *supra* note 125) but these are made "subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit."

139. Switzerland-United States (1996) provides in default of agreement for binding arbitration if both states and the taxpayer agree. This provision may have been included because of the lack of a treaty source rule.

C. Belgium, Japan and France

Belgium, Japan and France appear to create the same potential conflict between internal law and treaty source rules as the common law countries by requiring the source of income to be in the other state in their treaty relief articles. Belgium and Japan also refer to internal law rules in their treaties. However, the difference is that the internal law rules for giving relief do not contain any reference to source.¹⁴⁰

Belgium Where a resident of Belgium derives from sources within the United Kingdom [dividends, interest and royalties] the fixed proportion in respect of foreign tax from 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.¹⁴¹

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.¹⁴²

Since Japan regards treaty relief articles as merely confirming internal law rules,¹⁴³ which do not contain a source requirement, the expression "derives income from [the treaty partner state]" is not considered to be an independent requirement for the source to be in the other state.¹⁴⁴ We have, nevertheless, included Japan among states requiring the source to be in the other state on the grounds that in most of its treaties Japan includes this reference, which is not in the Model, to income being derived from the other state, even though Japan looks on this reference differently.

France does not give any credit under internal law and therefore does not refer to internal law credit rules but does require source in the other state.¹⁴⁵

France (a) Income other than that referred to in sub-paragraph (b) below 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; (b) Income referred to in Articles 10, 11, 13, 14, 16 and 17, received from Norway, shall be taxable in France, in accordance with the provisions of these Articles, on their gross amount. The Norwegian tax levied on this income allows to residents of

France a tax credit corresponding to the amount of Norwegian tax levied but which may not exceed the amount of French tax pertaining to this income.¹⁴⁶

In all these cases the treaty article is understood to have the same effect as the Model, that is to say the source of income is in a state if the income is taxable in that state in accordance with the treaty. It is odd that these countries go to the trouble of amending the Model to refer to source when it has no effect. It also has the disadvantage in Belgium and Japan, where there is a reference to internal law rules which must be to the rules from time to time in force, that the treaty partner risks those countries introducing internal law source rules narrower than the treaty implied source rules, which would mean that the scope of the relief could be reduced.¹⁴⁷ The same would be true in France by virtue of Article 3(2) if internal law rules were introduced, unless the context otherwise requires.

140 Belgium requires only that the interest or royalty has been subject to tax abroad. Japan does not require the source of income to be in the foreign state in order to give credit for the foreign tax. However, foreign source income is relevant in connection with the overall limitation. In calculating the overall limitation, only the foreign source income is included in the numerator of the overall limitation. This is presumably the reason for the source rule applying to Japan in Art. 5(1)(b) of Japan-United States (1971).

141 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 1/5th of the net interest; royalties - lump sum credit equal to 1/5th 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 per cent), 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), Philippines (1976).

142 Japan-Luxembourg (1992). This is the wording used in all of Japan's post-1980 treaties which we are considering. There are some earlier treaties which refer to income from sources in the other state (Pakistan (1959), Austria (1961), New Zealand (1963), Egypt (1968), United Kingdom (1969)) or income arising in the other state (Switzerland (1971)). The US treaty (1971) contains an article with source rules and the relief article refers to this. There is no reference to source in the relief article, only in the treaties with: South Korea (1970), Germany (1966, amended 1980), and Belgium (1968).

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

144 Compare the paragraph of the relief article in Belgium-Japan (1968) applicable to Belgium expressly referring to source ("In the case of income derived from sources in Japan which has been taxed in Japan in accordance with this Convention...") with that applicable to Japan avoiding any such reference ("... Belgian tax payable ... in accordance with the provisions of this Convention..."). This shows that the Japanese negotiators did not regard source as relevant.

145 Except in relation to the taxation of controlled foreign companies, and consolidation of foreign subsidiaries.

146 France-Norway (1980). The exemption provision in French treaties requires that the income should be taxable in the other state but not that it should have a source in the other state.

147 This assumes that the reference to internal law relief rules includes the residence state's source rules.

D. Germany

Of the countries represented using the exemption method in their treaties, Germany is the only example of a state requiring source in the other state as a condition for relief in its treaties. As Germany does not use the exemption method in internal law, the treaty article does not refer to internal law rules, as shown in paragraph 2(a) below. For credit, as shown in paragraph 2(b) below, the treaty relief is subject to internal law rules which do not make source in the other state a requirement, but source in the other state is required by the treaty provision.¹⁴⁸

- Germany
2. In the case of a resident of the Federal Republic of Germany, tax shall be determined as follows:
 - (a) Except as provided in subparagraph (b), there shall be excluded from the basis upon which German tax is imposed any item of income *from sources within the Kingdom of Norway* and any item of capital situated within the Kingdom of Norway which, according to this Convention, *may be taxed* in the Kingdom of Norway ...
 - (b) There shall be allowed as a credit against German income and corporate tax to be levied in respect of the following items of income *arising in the Kingdom of Norway, subject to the provisions of German tax law regarding credit for foreign tax*, the Norwegian tax paid under the laws of the Kingdom of Norway and in accordance with the provisions of this Convention: ...
 3. For the purposes of this Article, profits, income or gains of a resident of a Contracting State shall be deemed to arise from sources in the other Contracting State if they are *taxed* in that other Contracting State in accordance with this Convention.¹⁴⁹

Normally German treaties do not include a definition of source applicable to the exemption provision although there are a few treaties which do contain a provision similar to that used by Canada,¹⁵⁰ of which paragraph 3 above is an example. These provisions require that the income is actually taxed, as opposed to *may be taxed*, in the other country for the source to be treated as being in the other country.¹⁵¹ The drafting is extremely odd because this definition of source (meaning income which is actually taxed in the other state) is combined with a seemingly conflicting exemption provision applying to income which *may be taxed* in the other state in paragraph 2(a) in the above quotation. Literally, since the requirements are cumulative, exemption can apply only to income which is actually

taxed in the other state, so that the reference to exemption of income which may be taxed can never apply to income which is not taxed, but it is not clear whether this is intended. Professor Vogel has argued strongly that actual taxation is not required for exemption to apply under such a treaty provision.¹⁵² The *Bundesfinanzhof* has decided in two separate cases, in relation to the Canadian¹⁵³ and US¹⁵⁴ treaties, that the income must actually be taxed in the other state for exemption to apply. Since in those cases the income was not taxed in the other state there was nothing to prevent Germany from taxing under internal law. In the case on the Canadian treaty this treaty provision was distinguished from the one in the former US treaty (1954) according to which exemption in Germany applied if the income was not exempt under the treaty in the United States. The wording of the former treaty did not require actual taxation in the United States. Both treaties contain a cross-over provision saying that if income is categorized differently or attributed to different persons, resulting in no taxation in either state, Germany will apply credit instead of exemption, but the cross-over provision can never apply if, as the court has held, the treaty exemption provision requires actual taxation in the source state.¹⁵⁵

In other treaties not containing such a definition of source, Germany regards source for the purpose of the treaty to be determined under its internal law in accordance with Article 3(2). This does create a conflict with the treaty charging provisions. In a case under the former treaty with the United States, the German courts determined the source of employment income to be in the United States in the case where a German resident performed work in the United States for a German employer.¹⁵⁶ Even though the United States did not tax the income, probably because it was not paid while the employee was in the United States, this did

148. This is generally true of the post-1980 treaties under consideration, but exceptions are the treaties with: Bolivia (1992), Bulgaria (1987), Canada (1981), Egypt (1987), United States (1989), USSR (1981).

149. Germany-Norway (1991). Other German treaties making reference to internal law credit rules are those with: Australia (1972), Bulgaria (1987), Canada (1981), China (1985), Czechoslovakia (1980), Cyprus (1974), Egypt (1987), Finland (1979), Hungary (1977), Iceland (1971), India (1995), Indonesia (1990), Ireland (dual residence cases) (1962), Jamaica (1974), Japan (1966), Kenya (1977), Korea (1976), Kuwait (1987), Liberia (1970), Malta (1974), Mauritius (1978), Mexico (1993), New Zealand (1978), 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).

150. See *supra* note 130.

151. German treaties with: Canada (1981) (quoted *supra* in note 130), Italy (1989 in the protocol), New Zealand (1978), Norway (1991), Sweden (1992), United States (1989), Denmark (1995). In the credit provision of the treaties with the United States, Canada and Denmark there is no requirement for the source to be in the other state, but the others are in the same form as the treaty with Norway quoted in the text.

152. "Die Mär von den 'Rückfall-Klauseln' in Doppelbesteuerungsabkommen", *Internationales Steuerrecht* (1997) 6, Supplement to No. 24/97. These clauses are mentioned in a decision of the Regional Finance Office, Munich, discussed by A. Hauck in "Interpretation of the So-called 'Regress-Clauses' in Double Tax Treaties", *Intertax* 1996/2, at 52. The author takes issue with the tax department's statement that the income has actually to be taxed.

153. BFH 5 February 1992, BStBl II, 1992, 660.

154. BFH 11 June 1996, BStBl II, 1997, 117. It is understood that other cases are also pending on this provision.

155. The *Bundesfinanzhof* decision under the US treaty has been criticized by Hey in "International Steuerrecht" *RfW* 1997, at 82, for this reason.

156. BFH 31 July 1974 BStBl II, 1974, 61.

not affect Germany's determination of source to be in the United States, which led to no taxation in either country.

IV. CONCLUSION

In the first part of this article we considered source in relation to taxing rights and drew attention to the problem when interest is paid by¹⁵⁷ a permanent establishment that the interest has a dual source in two treaties in the form of the Model made by the recipient's residence state. Although the Commentary states that adoption of the Model by all three states involved solves the problem, we do not think that this is correct. Any solution requires the payer's residence state to give up its taxing right, and for tax to be charged in the state where the payer has a permanent establishment, but this should not be objectionable where there are treaties between all three states. It should be possible to have a treaty provision to safeguard the payer's residence state from giving up taxing rights to a state which does not exercise its right to tax the interest. We hope that the OECD will give consideration to amending the Model in this way and correcting the statements in the Commentary. It is also odd that the non-discrimination provisions dealing with the deductibility of the interest do not match the source provisions, although there is no problem of deductibility if there are treaties between all three countries involved.

Where source is made relevant to double taxation relief by the wording of the treaty which is not based on the Model, most states avoid any conflict between implied treaty source rules and internal law source rules. The common law states, including until recently the United States, avoid the problem by defining source to be in the other state provided it has taxing rights under the treaty, or, in the case of Canada, has actually taxed the income. In other states, such as Belgium, and possibly Japan, where treaty relief is given by reference to internal law rules, there are no conflicting internal law source rules. France does not refer to internal law relief rules but uses the undefined term source in the relief articles in its treaties. The greatest scope for conflict arises in Germany where the treaty requires source in the other state both in relation to exemption and credit: this is interpreted to mean source as understood under German law. The same problem now arises in the United States in relation to credit since the treaty double taxation relief article gives credit by reference to internal law rules and these rules require the income to have a source in the other state as understood in United States internal law. The only way of avoiding conflict in the United States is to use the mutual agreement article.

157. See *supra* note 17.

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