tiebreaker rule in Article 4(3) OECD and UN MC in conjunction with no. 8.2, second sentence, of the OECD MC 2008 Comm. on Article 4 can also be regarded as an anti-abuse provision.

62 M.no. 13 et seq. OECD Commentary on Article 1 illustrates several possibilities to deal with the issue of **conduit companies**. It explains the pros and cons of a look-through approach, a subject-to-tax approach, a channel approach, a bona fide clause and of comprehensive and complex limitation on benefits provisions. The limitation on benefits provisions will be analysed in more detail.

2. Limitation on Benefits Clauses

a. Overview

63 **Limitation on benefits clauses** are specifically designed to prevent treaty shopping. Treaty entitlement is made dependent on the taxpayer proving that he did not become resident of a Contracting State to obtain the benefits of the treaty concluded by this State. Being a simple resident is not enough. The taxpayer has to establish an additional nexus to the Contracting State by providing non-tax reasons for becoming or staying a resident of the Contracting State.

64 The **United States** was the first country to insert a provision into its tax treaties that denied treaty benefits under certain conditions.[168] The 1970 tax treaty between the United States and Finland already denied a corporation the application of the reduced rates on dividends, interest and royalties in the source State if the corporation was subject to a preferential rate in its residence State and at least 25 per cent of the shares of the corporation were held directly or indirectly by persons who were individuals not resident in the same State as the corporation.[169] A similar provision was then included in Article 16 of the first US Model of May 1976. Article 16 US MC of June 1981 and of the Discussion Draft of December 1981 expand the situations where treaty benefits are denied.[170] Article 22 US MC 1996 restructures the provisions and introduces some additional clauses. In 2006, Article 22 US MC is modified and tightened again. The OECD MC does not contain an LOB clause. In its 1998 Report on Harmful Tax Competition,[171] it already discussed the necessity of including an LOB clause and, in 2003, such clause was inserted in no. 20 of the Comm. on Article 1. This clause is based on the 1996 US MC. The 2014 BEPS Discussion Draft on Action 6 proposes the inclusion of an LOB clause into the OECD MC in a newly drafted Article X.[172] In the following, the US MC 2006 will be illustrated and due regard is given to the deviations contained in the OECD proposals in the Comm. and in the BEPS Discussion draft. The United States has inserted an LOB clause in nearly all of its treaties and is unwilling to conclude a

168. For a detailed analysis of the historical developments of LOB clauses see Rosenbloom, H.D., 15 *Law & Pol'y Int'l Bus.* 763 (1983).
169. Art. 27 DTC Finland/US 1970.
170. For the wording of these provisions see Vogel, 3rd ed., Art. 1 at m.no. 102 et seq.
171. See OECD, *Harmful Tax Competition An Emerging Global Issue*, 1998, para. 120.
172. OECD, *Public Discussion Draft of 14 March 2014 on BEPS Action 6: Preventing the granting of Treaty Benefits in Inappropriate Circumstances* at para. 11; Internet: <http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf> (last visited 28 May 2014); see now also *id., BEPS Action 6: Deliverable, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* of 16 September 2014 at 24 *et seq.*This proposal adds a derivative benefits clause.

tax treaty that does not contain an LOB clause.[173] LOB clauses can also be found in certain treaties concluded by India and Japan.[174]

65 Article 22 US MC contains several objective tests in paragraph 2(a)-(e) and paragraph 3. The fulfilment of one of these tests is sufficient for obtaining the benefits of the convention.[175] If none of these tests is fulfilled, treaty benefits may still be granted under the competent authority test contained in paragraph 4, which is based on subjective criteria. In contrast to individuals, Contracting States, political subdivisions or local authorities, who may always invoke treaty benefits without passing any test, a company is only entitled to treaty benefits if it meets one of the conditions set by paragraphs 2(c)-(e), 3 or 4 US MC. If a person fulfils the requirements of paragraph 2(c)-(e), it is regarded as a **'qualified resident'** and is entitled to treaty benefits with regard to **all of its income**. Concerning paragraphs 3 or 4, treaty entitlement may be **restricted to certain types of income**. The LOB clause concerns all treaty benefits granted by reason of residence especially the restrictions of the source State but also the obligation to grant relief from double taxation in the residence State.[176] Benefits based on nationality are not covered by Article 22 US MC.[177]

b. Article 22(2)(a) and (b) US MC 2006

66 An individual, a Contracting State or a political subdivision or local authority thereof are not suspect of treaty shopping; therefore, they are automatically granted treaty benefits.

67 Paragraph 2(b) of the OECD proposal contained in no. 20 of the Comm. on Article 1 instead uses the term **qualified governmental entity**. This provision has been taken over from Article 22(2)(b) of the US MC 1996. Article 3(3)(i) of the US MC 1996 defines the term 'qualified governmental entity'. It includes federal, State and local governments, certain government-owned corporations and other entities as well as certain pension trusts or funds that administer pension benefits described in Article 19 of the US MC 1996 (Government service).[178] As a result, paragraph 2(b) has a broader scope than Article 22(2)(b) of the US MC 2006.

c. Article 22(2) (c) US MC 2006

68 *aa.* A **publicly traded company** or a **subsidiary of publicly traded companies** may qualify for treaty benefits as it can be assumed that it has a sufficient nexus to its residence State where its shares are traded. Due to the strict requirements for listing a company on a stock exchange, it is difficult to use a publicly traded company for treaty shopping purposes.[179] A company resident in a Contracting State is entitled to all benefits of the treaty if the principal class of its shares, and – if it exists – any disproportionate class of shares, are regularly traded

173. However, the old DTC Hungary/US 1979 and DTC Poland/US 1974 still do not contain an LOB clause. The new treaties close this gap but are not yet in force; see Art. 22 DTC Hungary/US 2010 and Art. 22 DTC Poland/US 2013. The old DTC Iceland/US 1975, which did not have an LOB clause either, was replaced in 2007 and now contains an LOB clause in Art. 21.
174. See, e.g., Art. 29 DTC India/UAE 1993/2007, Art. 3 Prot. of the DTC India/Singapore 1994/2005, the new draft treaties with Cyprus and Mauritius are also supposed to have an LOB clause; for Japan see, e.g., Art. 22 DTC Japan/UK 2006, Art. 21 DTC Japan/Netherlands 2010/2012, Art. 22A DTC Japan/Switzerland 1971/2010 and Matsuda, N., 61 *BIT* 239 (2007).
175. If the requirements of the objective tests are fulfilled, it does not matter whether such resident was formed or availed of for treaty shopping purposes.
176. See Vega Borrego, F.A., *Limitation on Benefits Clauses in Double Taxation Conventions* (2006) at 94; for the benefits of Art. 23 see e.g. US Tech. Expl. Art. 22 § 353.
177. See e.g. Art. 24(1) OECD, UN and US MC.
178. See also the US Tech. Expl. Art. 3 of the US MC 1996.
179. Vega Borrego, F.A., *Limitation on Benefits Clauses in Double Taxation Conventions* (2006) at 127.

http://www.pbookshop.com

on one or more recognized stock exchanges. In addition, the company must at least satisfy one of the following tests: first, the company's principal class of shares must be primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or, second, its primary place of management and control has to be located in its residence State. A company that is not publicly traded may nevertheless benefit from treaty benefits if at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under Article 22(2)(c)(i) US MC, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State.

69 The term **'recognised stock exchange'** is defined in paragraph 5(a). Although stock exchanges located in third countries can also be included in the list, in practice this is only rarely the case. The requirement that the shares must be regularly traded prevents a company that is just listed on a stock exchange from obtaining treaty benefits. The term **'regularly traded'** is not defined in the US MC. It requires a certain trading volume and a certain trading frequency. Its interpretation can be derived from domestic law in accordance with Article 3(2). In the United States, the term is interpreted in light of Treasury Regulation Section 1.884-5(d)(4)(i)(B), according to which trades in the shares must be made in more than de minimis quantities on at least 60 days during the taxable year and the aggregate number of shares traded must be at least 10 per cent of the average number of shares outstanding during the year.[180] If a company not only has a **'principal class of shares'** but also a **'disproportionate class of shares'** outstanding, then both classes of shares must be regularly traded.[181]

70 As a first alternative for obtaining access to treaty benefits, its 'principal class of shares' must be **primarily traded** on one or more recognized stock exchanges situated in the residence State of the company. The term 'primarily traded' is not defined in the US MC and can be construed in accordance with Article 3(2) US MC in light of domestic law.[182] If the United States is applying the provision, it understands the term in line with Treasury Regulation Section 1.884-5(d)(3). The requirement is met if more shares are traded on recognized stock exchanges in the residence State than on securities markets in any other country.

71 The alternative **'primary place of management and control'** test permits the company to qualify for treaty benefits in cases where the recognized stock exchange in its residence State is not sufficiently large. The term is defined in Article 22(5)(d) US MC.[183]

72 *bb. Subsidiary of Publicly Traded Companies.* A company that is not publicly traded may be entitled to treaty benefits under Article 22(5)(c)(ii) if its shareholders are publicly traded companies. This provision permits the outsourcing of certain activities to subsidiaries without losing treaty benefits. It is required that at least 50 per cent of the aggregate vote and value of the shares (and if they exist, also at least 50 per cent of any disproportionate class of shares) is directly or indirectly owned by five or fewer publicly traded companies that are entitled to treaty benefits under subparagraph (i)(A) or (B). The interposition of companies that are not entitled to treaty benefits does not harm as long as the ultimate owners are entitled to treaty benefits ('indirect ownership') and the intermediary shareholders are residents of either Contracting State. It is not necessary that the publicly traded companies are residents of the same Contracting State as the company seeking treaty benefits as long as the publicly traded companies are residents of a Contracting State.[184] The limitation to five publicly traded companies as shareholders was chosen to enable joint ventures without completely watering down the publicly traded test. Treaty entitlement is limited to **companies issuing shares**. This is evidenced by a comparison with the text of paragraph 2(e)(i) that makes a distinction between shares and other beneficial interests and also by the French language versions in the

180. US Tech. Expl. Art. 22 § 319; Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 50.
181. For the definition of these terms see Art. 22(5)(b) and (c) US MC.
182. US Tech. Expl. Art. 22 § 321; Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 53.
183. See also US Tech. Expl. Art. 22 § 322; Wolff, U., *id.* at m.no. 55.
184. See the example in US Tech. Expl. Art. 22 § 326; Wolff, U., *id.* at m.no. 61.

treaties with France and Canada, which speak of '*actions*'.[185] As a result, a GmbH, an S.à.r.l. or a partnership even if treated as a body corporate for tax purposes do not qualify for treaty benefits under this provision.

d. Article 22(2)(d) US MC 2006: Tax-Exempt Organizations

73 The US MC distinguishes between two different types of tax exempt entities. A pension fund (Art. 4(2)(a) US MC) qualifies for treaty benefits if more than half of the fund's beneficiaries, members or participants are resident in either Contracting State. The 50 per cent requirement hinders the creation of pension funds by multinational enterprises as their employees are typically resident in several States.[186] It obliges multinational enterprises to set up a pension fund for each State in which it operates. **Tax-exempt organizations other than pension funds** automatically qualify for treaty benefits – without regard to the residence of their beneficiaries or members – if they are organized and operated exclusively to fulfil religious, charitable, scientific, cultural or educational purposes.[187]

74 Article X(2)(d)(iii) of the BEPS OECD draft also grants access to treaty benefits to **investment funds** provided that they derive substantially all of their income from investments made for the benefit of individuals resident in one of the two Contracting States.[188]

e. Article 22(2)(e) US MC 2006: Ownership/Base Erosion Test

75 The **ownership and base erosion test** gives companies that are not listed on a stock exchange or are not subsidiaries of listed companies access to treaty benefits.[189] The base-erosion prong of the provision is designed to prevent conduit companies from benefiting from the treaty.[190] The taxpayer is only regarded as a qualified person if it simultaneously complies with both the ownership and the base-erosion clause.

76 *aa. Ownership prong.* The requirements of the **ownership clause** are met if at least 50 per cent of the shares or other beneficial interests of the person are owned – directly or indirectly – by persons that are qualified persons under paragraph 2(a) (individuals), 2(b) (the

185. See Art. 30(2)(c)(ii) DTC France/US 1994/2009, speaking of '*droit de vote et de la valeur des actions*', in contrast to para. (2)(e)(i) speaking of 'actions ou tout autre droit dans cette personne' and Art. XXIX A (2)(d) DTC Canada/US 1980/1997; also Art. 28(2)(c)(bb) DTC Germany/US 1989/2006 speaking of '*Aktien*. See Simontacchi, S., *Taxation of Capital Gains under the OECD Model Convention (2007)*, 344; Wassermeyer, F. & Schönfeld, J., *DB* 1970, 1972 (2006). Differing opinion: Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 62.
186. Vega Borrego, F.A., *Limitation on Benefits Clauses in Double Taxation Conventions* (2006) at 124.
187. See US Tech. Expl. Art. 22 § 327; many treaties used or still use the term 'not-for-profit organisation', see, e.g., Art. 28(1)(f) DTC Germany/US 1989. Similar provisions can be found, e.g., in Art. 16(1)(f) DTC Finland/US 1989, Art. 24(2)(f) DTC Luxembourg/US 1996, Art. 17(1)(e) DTC Mexico 1992/2002 and Art. 18(1)(f) DTC Thailand/US 1996. The German *Finanzgericht* of Cologne of 24 October 2002, 2 K 6627/96, *BeckRS* 21013487 (2002), held that the question whether an entity can be regarded as a not-for-profit organization has to be decided according to the law of the Contracting State in which the organization is established. The other Contracting State may not apply its own criteria regarding the status of a not-for-profit organization.
188. OECD, *Public Discussion Draft of 14 March 2014 on BEPS Action 6: Preventing the granting of Treaty Benefits in Inappropriate Circumstances* at para. 11; Internet: <http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf> (last visited 28 May 2014).
189. For instance, a German GmbH or a French SARL may benefit from this clause.
190. Gohr, M., in: E/J/G/K, Art. 28 m.no. 70; Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 85; Rosenbloom, H.D., 58 *TNI* 649, 650 (2010) deplores that the provision is ineffective if the Residence State of the conduit is willing to grant tax credits to companies owned by foreign investors. He also criticizes that the publicly traded test and the active trade and business test do not comprise a base-erosion prong.

http://www.phookshop.com

Contracting States), 2(c)(i) (publicly traded companies) or 2(d) (tax-exempt organizations).[191] The owners must be residents of the same Contracting State as the taxpayer;[192] in case of indirect ownership, each intermediate owner must be a resident of that State as well. In contrast to the base-erosion prong, it is not sufficient that the owners are resident in the other Contracting State. According to Article 4(1) US MC, US citizens living in a third State also count as US residents for the ownership prong. There is no limit for the number of owners. Minority shareholders are to be taken into account as well. The threshold of exactly 50 per cent enables joint ventures in which qualified persons and third-country residents participate on an equal footing.[193] If the taxpayer has issued several classes of shares, then 50 per cent of each class must be held by the qualified persons mentioned above. The shareholding may fall temporarily below the 50 per cent ownership requirement provided that this requirement is met on at least half of the days of the taxable year.

77 *bb. Base-erosion prong.* The **base erosion test** ensures that the source State only has to grant treaty benefits if the income is taxable in the other Contracting State. If the income is, inter alia, passed on to third-country residents in the form of deductible payments that erode the tax base of the other Contracting State, treaty benefits are denied. Article 22(1)(e)(ii) US MC requires that less than half of the taxpayer's gross income is paid or accrued – directly or indirectly – to persons who are not qualified persons under paragraph 2(a), (b), (c)(i) or (d) resident in either Contracting State in the form or deductible payments.[194] Payments that are at arm's length and made in the ordinary course of business for services or tangible property are not taken into consideration as deductible payments. This means that payments to third-country residents as well as payments to residents of either Contracting State who do not qualify under the paragraphs mentioned above are harmful.

78 The term **'gross income'** is not defined in the US MC. It has to be interpreted in line with the domestic law of the Contracting State in which the taxpayer seeking access to treaty benefits is a resident.[195] To determine whether the tax base of this country is eroded, the law of this country has to be applied. In the United States, the gross income is the difference between gross receipts and the cost of goods sold.[196] The lower the amount of the gross income, the more difficult it is for the taxpayer to gain access to treaty benefits. Similarly, the question whether a payment is deductible has to be answered in conformity with the domestic law of the residence State of the taxpayer. If the domestic law disallows a deduction (e.g., due to the application of thin capitalization rules) the payments are not taken into account.[197] According to the US MC 1996, payments made to a third-country resident and attributable to a PE located in the residence State of the taxpayer did not count either. As this exception is no longer contained in the US MC 2006, it can be concluded that deductible payments are harmful even if attributable to a PE situated in the residence State of the taxpayer. Arm's length payments in the ordinary course of business for services or tangible property, depreciation and amortisation allowances are to be disregarded.[198]

79 The base erosion test also applies to **indirect payments**. If the direct recipient is a 'qualified person' mentioned in paragraph 2(e)(ii) but acts as conduit and passes on the payments to a person resident in a third country or to a resident of one of the Contracting States that is not a 'qualified person' mentioned above, then the test is not passed either. The policy behind the provision to deny treaty benefits if the tax base in the residence State of the taxpayer is eroded speaks in favour of regarding payments made by the intermediary recipient as harmful only if these payments are deductible in that State.[199]

f. Derivative Benefits Clause

80 A **derivative benefits clause** is structured in a similar way as the ownership and base erosion clause and also deploys an objective test. Neither the US MC nor the OECD proposal in the Comm. to Article 1 contain a derivative benefits clause. However, most treaties concluded between the United States and EU Member States have included such clauses to avoid conflicts with the fundamental freedoms of the TFEU.[200] The OECD debated the inclusion of a derivate benefit clause in its Discussion Draft on BEPS Action 6 of 14 March 2014[201] and

191. It was not necessary to include qualified persons under paragraph 2(c)(ii) as in this situation the taxpayer is indirectly owned by a publicly traded company. However, ownership under paragraph 3 or 4 is not sufficient. The ownership test is easier to fulfil in a large country. In small countries with investors located in neighbouring countries, this test is often not satisfied.
192. In the US MC 1996 it was still sufficient that the owners were resident in one of the two Contracting States.
193. Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 86.
194. The OECD proposal in the Comm. to Art. 1 is easier to fulfill. Here, all payments made to residents of either Contracting State are admissable. In the OECD proposal it is not necessary that the recipients are qualified persons in the sense of paragraph 2(a), (b), (c)(i) or (d).
195. See the clear wording: 'as determined in the persons's State of residence'; see also Rosenbloom, H.D., 58 *TNI* 649, 650 (2010), who illustrates the initial reticence of the United States to interpret the term 'gross income' in line with the other treaty partner's law; Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 100. However, Vega Borrego, F.A., *Limitation on Benefits Clauses in Double Taxation Conventions* (2006) at 160, tries to find an autonomous meaning of the term 'gross income' as this term is defined in many treaties; see, e.g., Art. 17(4) DTC Spain/US 1990, Art. 17(3) DTC Czech Republic/US 1993 and Art. XV of the 2004 Memorandum of Understanding of the DTC Netherlands/US 1992/2004.
196. For Germany, the term '*Rohgewinn*' is understood as the difference between 'turnover' and the 'costs of goods sold'; see Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 100; Gohr, M., in E/J/G/K, Art. 28 m.no. 83.
197. Vega Borrego, F.A., *Limitation on Benefits Clauses in Double Taxation Conventions* (2006) at 164 & 132.
198. US Tech. Expl. Art. 22 § 331. However, some treaties do not contain an exception for arm's length payments; see, e.g., Art. 28(2)(f)(bb) DTC Germany/US 1989/2006.
199. See Bates, J. *et al.*, 41 *Intertax* 395, 399 (2013).
200. See, e.g., Art. 30(3) and (7)(f) DTC France/US 1994/2009, Art. 28(3) and (8)(e) DTC Germany/US 1989/2006, Art. 24(4) DTC Luxembourg/US 1996, Art. 26(3) and (8)(f) DTC Netherlands/US 1992/2004, Art. 23(3) and (7)(d) DTC UK/US 2001/2002. Derivative benefits clauses can also be found in treaties concluded with Japan; see, e.g., Art. 22A(3) and (7)(d) DTC France/Japan 1995/2007, Art. 22A(3) and (8)(d) DTC Japan/Switzerland 1971/2010, Art. 22(3) and (7)(e) DTC Japan/UK 2006. After ECJ of 5 November 2002, Case C-466-469/98, Case C-471-472/98, *Comm. v. UK et al.*, ECR I, 9427 (2002) and of 12 December 2006, Case C-374/04, *ACT Group Litigation*, ECR I, 11673 (2006), it is still disputed whether an EU Member State may negotiate an LOB clause that penalizes domestic enterprises owned by residents of other Member States; see for this dispute, e.g., Kofler, G., 41 *TNI* 45 (2004), Bates, J. *et al.*, 41 *Intertax* 395, 403 (2013); Mason, R., 43 *TNI* 563 (2006) and Calejo Guerra, J., 51 *ET* 85 (2011). There are good reasons to argue that an EU Member State is not allowed to enter into an agreement that permits a third State to discriminate against companies owned by residents of other EU Member States. While the fight against treaty shopping may justify a different treatment, all measures have to be proportionate. To the extent that setting up a company in another country does not lead to the application of a more favourable tax treaty, a treaty shopping motivation can be excluded. It would be disproportionate to deny treaty benefits in this situation. EU aspects are also taken into consideration within the framework of the bona fide clause (see *infra* m.no. 90), see e.g. Memorandum of Understanding re: Art. 16(2) DTC Austria/US 1996, Memorandum of Understanding No. XXVIII(c) re. Art. 26(7) DTC Netherlands/US 1992/2004. However, a discretionary relief provision is not sufficient to comply with the fundamental freedoms, see ECJ of 28 June 1977, 11/77, *Patrick*, ECR 1199 (1977) para. 14/15.
201. OECD, *Public Discussion Draft of 14 March 2014 on BEPS Action 6: Preventing the granting of Treaty Benefits in Inappropriate Circumstances* para. 13; Internet: <http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf> (last visited 28 May 2014). The OECD did

http://www.phookshop.com

drafted such clause in its BEPS Action 6: Deliverable Report of September 2014.[202] The first derivative benefits clause in a tax treaty was contained in Article 17(3)(b) DTC Jamaica/United States 1980/1981[203] and with regard to an EU Member State in Article 26(4) DTC Netherlands/United States 1992. The territorial scope of this draft provision is not restricted to the EU. The underlying idea of a derivative benefits clause is that a company should be entitled to treaty benefits if its owners were entitled to the same benefits had they received the income directly without interposition of the company. In this situation, the chosen structure was not motivated by tax reasons and treaty shopping can be excluded.[204] According to this clause, a company is entitled to all benefits of the Convention if it is owned by **'equivalent beneficiaries'** and does not pass on 50 per cent or more of its gross income in the form of deductible payments to persons that are not 'equivalent beneficiaries'. The ownership and the base erosion test must be fulfilled simultaneously.

81 *aa. Ownership prong.* At least 95 per cent of the aggregate voting power and value of its shares – and if a disproportionate class of shares exists, at least 50 per cent of this class of shares as well – must be directly or indirectly owned by seven or fewer persons that are **equivalent beneficiaries**.[205] An equivalent beneficiary is defined as a resident of either Contracting State that is a qualified person by virtue of paragraph 2(a) (individual), 2(b) (Contracting State), 2(c)(i) (publicly traded company) or 2(d) (tax exempt entity). Alternatively – and this is the most common application of this provision – residents of third States that would be entitled to the benefits of a comprehensive tax treaty between the source State and the third State under a provision similar to paragraph 2(a), (b), (c)(i) or (d) also count as equivalent beneficiaries. If the tax treaty between the source State and the third State does not contain an LOB clause, the tax treaty between the source State and the residence State of the taxpayer will be applied in a fictitious way: It has to be determined whether the owner had passed the tests of the LOB clause had he been a resident of the same State as the taxpayer. With regard to dividends, interest and royalties, the maximum rates contained in the treaty between the source State and the residence State of the taxpayer have to be compared with the maximum rates contained in the treaty between the source State and the residence State of the owner. The ownership prong is only fulfilled if the maximum rate in the treaty with the residence State of the owner is at least as low as the maximum rate in the treaty with the residence State of the taxpayer.[206] If this threshold is exceeded, all treaty benefits are denied and the taxpayer is subject to the domestic tax rates. The taxpayer is not allowed to claim the maximum rate contained in the treaty with the residence State of the owner.[207] In case of **indirect ownership**, each intermediate owner must itself be an equivalent beneficiary.[208]

82 *bb. Base-erosion prong.* The **base erosion test** in the derivative benefits clause is similar to the base erosion test contained in Article 22(2)(e)(ii) US Model (see *supra* at m.no. 77).

not include this derivative benefit clause in Art. X of the proposal as it voiced its concern about base erosion; see the example in para. 15.

202. OECD, *BEPS Action 6: Deliverable, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* of 16 September 2014 at 27. The provision is contained in Art. X(4) which is added in brackets.
203. See also Avi-Yonah, R. & Halabi, O., 66 *BIT* 236, 240 (2012).
204. Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 86; Kofler, G., 41 *TNI* 45, 68 (2004).
205. The 95 per cent requirement avoids harsh results if minority shareholders are not qualified persons, see Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 113.
206. In many treaties, it is sufficient if the owner would be entitled to claim the same maximum rate by virtue of other provisions, e.g., the Parent-Subsidiary Directive or the Interest and Royalties Directive; see, e.g., Art. 16(7)(h) DTC Finland/US 1989/2006 and Art. 28(8)(f) DTC Germany/US 1989/2006.
207. See Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 113; Mason, R., 43 *TNI* 563, 566 (2006), however, argues in favour of a teleological interpretation: in certain situations the taxpayer should be able to claim the reduced rate contained in the treaty with the Residence State of the owner.
208. This requirement is difficult to understand. If the intermediate owner is already an equivalent beneficiary, it is no longer necessary to go back to the indirect owner.

Here, less than 50 per cent of the company's gross income must be passed on in form of deductible payments to persons that are **not equivalent beneficiaries**.

g. Article 22(3) US MC 2006: Active Trade or Business Test

83 A taxpayer may also be entitled to treaty benefits if he exercises an **active business activity**. In contrast to the other tests, treaty benefits in accordance with paragraph 3 are only granted with respect to **particular items of income** if these items of income are related to the business activity. This test only applies to persons other than individuals, as individuals are already entitled to treaty benefits with respect to the totality of their income pursuant to paragraph (2)(a). The test is especially relevant for dividend, interest, rents and royalties paid to the taxpayer by a connected person.[209] Concerning business income, a treaty does not restrict taxation in the source State once the PE threshold is passed.

84 The test is met if the resident is engaged in the **active conduct of a trade or business** in its residence State and the income earned in the other Contracting State is derived **in connection with** the trade or business or is **incidental** to the trade or business. In addition, the trade or business activity carried on in the residence State must be **substantial** in relation to the trade or business activity in the other Contracting State. Activities conducted by **connected persons** are to be attributed to the taxpayer. The **attribution** is important for the question of whether the taxpayer is engaged in the active conduct of a trade or business, whether the income is derived in connection to or is incidental to the trade or business and whether the activity is substantial. This means that a holding company may fulfil the requirements of paragraph 3 if its subsidiaries are engaged in the active conduct of a trade or business.

85 **Active conduct of a trade or business**: Article 30(4a) DTC France/US 1994/2004 uses the term *'une activité industrielle ou commerciale effective'*; Article XXIX (3) DTC Canada/US 1980/2007 uses *'exerce activement des activités industrielles ou commerciales'* in the French language version; Art. 28(4)(a) DTC Germany/US 1989/2006 uses *'wenn die ansässige Person … aktiv gewerblich tätig ist'* in its German language version. The terms are not defined in the treaties. The provision only states in a negative way that the business of making or managing investments for the resident's own account is not to be regarded as an active conduct of a trade or business. However, it makes an exception if those activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer. An active conduct of a trade or business requires not only managerial but also operational activities. A pure management holding company does not meet this test. The German Tax Court of Cologne held that an activity that is only deemed to be a business activity by virtue of the legal form of the company does not fall within the ambit of an active conduct of a trade or business.[210] In the United States, the term is interpreted in light of its domestic tax law in accordance with Article 3(2) of the respective treaty. The regulations under Section 367(a) IRC are used as a guidance for the interpretation of the term 'active conduct of a trade or business'.

86 **In connection with**: According to the US Technical Explanation, an item of income is derived in connection with a trade or business if the income-producing activity in the source State is a line of business that **'forms a part of'** or is **'complementary'** to the trade or business conducted in the residence State by the recipient of the income.[211] By way of the attribution rules, activities conducted by connected persons count as activities of the income recipient. If the activities in both Contracting States are similar or if both activities form

209. See Bates, J. *et al.*, 41 *Intertax* 395, 400 (2013); Wolff, U., in: Wassermeyer, Art. 1 DBA USA at m.no. 126.
210. German *Finanzgericht Köln* of 18 December 1997, 2 K 7369/94, *EFG* 927 (1998): DTC Germany/US 1989.
211. US Tech. Expl. Art. 22 § 336.

http://www.phookshop.com

UN MC

4. The provisions of Paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise *and to income from immovable property used for the performance of independent personal services.*

US MC

4. The provisions of Paragraphs 1 and 3 shall also apply to the income from *real* property of an enterprise.

5. *A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the property is situated agrees to terminate the election.*

OECD MC Commentary

Concerning the taxation of income from immovable property

1. **[Scope]** Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source. Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral treaties to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of Paragraph 1 of Article 21 shall apply to such income. → *4, 10, 53, 70*

2. **[Concept of immovable property]** Defining the concept of immovable property by reference to the law of the State in which the property is situated, as is provided in Paragraph 2, will help to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not. The paragraph, however, specifically mentions the assets and rights which must always be regarded as immovable property. In fact such assets and rights are already treated as immovable property according to the laws or the taxation rules of most OECD member countries. Conversely, the Paragraph stipulates that ships, boats and aircraft shall never be considered as immovable property. No special provision has been included as regards income from indebtedness secured by immovable property, as this question is settled by Article 11. → *12, 18, 98, 113* et seq., *214*

2.1 **[Agriculture or forestry]** The phrase 'including income from agriculture or forestry' in paragraph 1 extends the scope of Article 6 to include not only income derived from immovable property as defined in paragraph 2 but also income from activities that constitute agriculture or forestry. Income from agriculture and forestry includes not only the income that an enterprise engaged in agriculture or forestry derives from selling its agricultural and forestry production but also income that is an integral part of the carrying on of agriculture or forestry activities – for instance, income derived from the acquisition or trading of emissions permits (the nature of these permits is explained in paragraph 75.1 of the Commentary on Article 7) where such acquisition or trading is an integral part of the carrying on of agriculture or forestry activities, *e.g.* where the permits are acquired for the purpose of carrying on these activities or where permits acquired for that purpose are subsequently traded when it is realised that they will not be needed. → *52* et seq.

3. **[Form of exploitation]** Paragraph 3 indicates that the general rule applies irrespective of the form of exploitation of the immovable property. Paragraph 4 makes it clear that the provisions of Paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises. Income in the form of distributions from Real Estate Investment Trusts (REITs), however, raises particular issues which are discussed in Paragraphs 67.1 to 67.7 of the Commentary on Article 10. → *164*

4. **[Priority]** It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner in which income from immovable property is to be taxed. → *50, 240, 244, 247, 252* et seq.

http://www.pbookshop.com

[*No Observations on the Commentary*]

Reservations on the Article

→ 121 5. ***Finland*** reserves the right to tax income of shareholders in Finnish companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in Finland and held by the company, where such right is based on the ownership of shares or other corporate rights in the company.

→ 43, 45 6. ***France*** wishes to retain the possibility of applying the provisions in its domestic laws relative to the taxation of income from shares or rights, which are treated therein as income from immovable property.

→ 121 7. ***Spain*** reserves its right to tax income from any form of use of a right to enjoyment of immovable property situated in Spain when such right derives from the holding of shares or other corporate rights in the company owning the property.

8. ***Canada*** reserves the right to include in Paragraph 3 a reference to income from the alienation of immovable property.

→ 56 9. ***New Zealand*** reserves the right to include fishing and rights relating to all natural resources under this Article.

10. The ***United States*** reserves the right to add a Paragraph to Article 6 allowing a resident of a Contracting State to elect to be taxed by the other Contracting State on a net basis on income from real property.

11. ***Australia*** reserves the right to include rights relating to all natural resources under this Article.

12. ***Mexico*** reserves the right to treat as immovable property any right that allows the use or enjoyment of immovable property situated in a Contracting State where that use or enjoyment relates to time sharing since under its domestic law such right is not considered to constitute immovable property.

13. ***Estonia*** reserves the right to include in the definition of the term 'immovable property' any right of claim in respect of immovable property because such right of claim may not be included in its domestic law meaning of the term.

14. ***Israel*** reserves the right to include in paragraph 2 'any option or similar right to acquire immovable property'.

Non-OECD Economies' Positions

Positions on the Article

Paragraph 1

1. ***India*** and ***Indonesia*** wish to address the issue of the inclusion of the words 'including income from agriculture or forestry' through bilateral negotiations.

Paragraph 2

2. Given the meaning of the term 'immovable property' under its domestic law, ***Belarus*** reserves the right to omit the second sentence of this paragraph.

2.1 ***Latvia*** and ***Lithuania*** reserve the right to include in the definition of the term 'immovable property' any option or similar right to acquire immovable property.

2.2 ***Colombia*** reserves the right to include rights relating to all natural resources under this Article. Colombia also reserves the right to amend the definition of 'immovable property' to include expressly other property.

3. ***Lithuania*** reserves the right to modify the second sentence of the definition of the term 'immovable property' to make clear that the sentence does not apply for domestic law purposes.

3.1 ***Morocco*** wishes to retain the possibility of applying the provisions in its domestic laws relative to the taxation of income from shares or rights, which are treated therein as income from immovable property.

Paragraph 3

4. ***Latvia*** and ***Lithuania*** reserve the right to include in Paragraph 3 a reference to income from the alienation of immovable property.

5. ***Latvia*** and ***Lithuania*** also reserve the right to tax income of shareholders in resident companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in their country and held by the company, where such right is based on the ownership of shares or other corporate rights in the company.

[*No Positions on the Commentary*]

http://www.pbookshop.com

qualify as 'the business of an enterprise' under Article 7(1) and (2) OECD MC (on the consequences, see *infra* m.no. 240 et seq.)

7. Situated in the Other Contracting State

63 Once the residence State is established unambiguously (*supra* m.no. 49), it is necessary to determine if the immovable property falls within the **territorial boundaries** of the other Contracting State. This positive requirement has been inserted by the OECD MC 1977. Compared to the 1977 version, Article 6 OECD MC 1963 was terser and less specific, as it did not limit its application to immovable property 'situated in the other Contracting State' but assigned primary taxation to the situs State anyway, irrespective of which of the two Contracting States was the situs State.

64 A full description of the boundaries of the two Contracting States is not provided for in the OECD MC, although Article 29 OECD MC has some relevance thereto. Indeed, many bilateral DTCs do contain at least some general clarifications on the **territory** of each **Contracting State** in their Article 3(1) (see *supra* Article 3 at m.no. 99 et seq.). These clarifications aim at settling disputes or doubts arising under domestic or general international law, or any mismatch between the bilateral viewpoints. In particular, coastal States tend to confirm their territorial claims to the coastal sea, to the continental shelf, or to rights to use or exploit the seabed or the soil underneath the seabed (e.g., the three or twelve nautical mile limits). Another typical feature of these clarifications is the inclusion or exclusion of customs enclaves and free-trade zones.

a. Determination of the Situs of Land

65 The Contracting State in which a plot of land is situated is usually easy to determine. Issues only arise if the plot of land does not lie completely within the **physical borders of one Contracting State**, as accepted by international treaties or principles of international law (e.g., a portion thereof is located in either the residence State or a third State, or is claimed or shared by two or more sovereigns). Similar issues may arise in connection with submerged land (e.g., the three-miles or twelve-miles territorial limits adopted by various coastal States and the continental shelf beyond such limits). If existing agreements between the Contracting States, or the specific DTC, does not address the circumstances at issue (see *supra* m.no. 64), the portion thereof in each Contracting State must be treated separately, according to its physical location.[25] For properties that are situated in areas claimed or shared by two sovereigns, double taxation can only be avoided or eliminated by mutual agreement (Article 25(3), second sentence OECD and UN MC).

b. Determination of the Situs of Assets Other than Land

66 If a tangible asset that has been defined by the OECD and UN MC or domestic law as 'immovable property' is, in fact, mobile (such as livestock, farming equipment, and logging equipment), it is considered to be located where the land on which such tangible asset is typically located, even if the **tangible asset** moves from that location from time to time or for some period of time. For example, cattle belonging to a farm located in State A, which sometimes graze across the border on land in State B, are considered to be 'situated' in State A.

25. Wassermeyer, F., in: Wassermeyer, Art. 6 OECD MC at m.no. 42; cf. Austrian BMF, EAS 1012 of 10 February 1997, 7 *SWI* 160 (1997).

67 Similarly, if the immovable property is an **intangible asset** or **right** to make use of or exploit the natural resources of the land of another (e.g., usufructs, easements, air rights, grazing rights, mineral extraction rights), such intangible assets are located in the same place where the land to which those rights attach is situated. Thus, in the example above, although the cattle themselves are deemed to be situated in State A, the intangible grazing rights granted to the farmer in State A are situated in State B, as that is where the land to which the grazing rights attach is located. It is irrelevant whether the land is actually used for the purposes mentioned in the grant of the right (e.g., if the State A cattle do not, in fact, graze in State B), or that the natural resources sought to be exploited in fact exist on or under the land (e.g., mineral rights associated with land that does not, in fact, have any such minerals)[26] as long as the intangible asset are legally or economically connected thereto.

68 Likewise, where bilateral DTCs (deviating from the OECD and UN MC; see *supra* m.no. 43 et seq.) consider income from **shares of real estate companies**, including any (actual or imputed) income from the enjoyment of immovable property and held by that company, not to be 'dividends' but 'income from immovable property', the situs State of such income is where the land held or used by the company (or the land to which its intangible rights are attached) is located (*infra* m.no. 237).

c. Immovable Property in the residence State

69 If, after applying the foregoing rules, it appears that the immovable property is located in the **taxpayer's residence** State or in any third State (i.e., not in 'the other Contracting State'), such immovable property does not fall within the scope of Article 6 OECD and UN MC. In such circumstances, Article 7 OECD and UN MC (*supra* m.no. 7 et seq.) or Article 21 OECD and UN MC (*supra* m.no. 27) apply.

8. Connection between Asset and Income

70 To fall within the scope of Article 6(1) OECD and UN MC, the income must be derived **'from'** the immovable property. No. 1 OECD MC Comm. on Article 6 **reinforces** the **connection** between the immovable property and the income when it talks of 'property producing … income' (French version: *le bien … qui produit ce revenu*). Article 6(3) OECD and UN MC further clarifies the limits of the application of Article 6(1) OECD and UN MC in that it requires some form of 'use' of the immovable property asset, viz. (a) an direct, that is, active use (regularly by the asset holder himself); (b) the letting, that is, a passive use (by granting a right to another person to directly use, or to sub-let, the asset); or (c) any other form of use of the immovable asset. Thus, if income is not connected with any form of 'use' of the immovable property, another Article would apply.

71 A question could arise as to whether a payment received for the **non-use of an immovable property** asset (e.g., a payment made to farmer under a market support programme not to plant a particular plot of land) would fall within the 'use' requirements of Article 6(3) OECD and UN MC; however, non-use when one has the right to use, qualifies as a 'use in any other form', such that such income from non-use would fall within Article 6OECD and UN MC (see *infra* m.no. 224 et seq.).

26. Cf. Art. 6(2)(ii) of the DTC between Australia and the US: 'where the natural resources are situated or sought'.

http://www.pbookshop.com

II. Divergent Country Practice

72 Treaty practice of most countries in the world follows the design of Article 6(1) OECD and UN MC.

1. No Restriction to Situs 'in the Other Contracting State'

73 However, old DTCs (like the 1963 OECD MC) do not require the immovable property to be located 'in the *other* Contracting State' (see *supra* m.no. 63 et seq.) but assign **primary taxation** to the Contracting State in which such **property is situated**. In this case, the Article 6 OECD and UN MC-equivalent applies equally to immovable property situated in the residence State. This does not pose any problems where the rule provides for exclusive taxation ('is taxable only') in that State. However, if the rule (like the 1963 OECD MC) is drafted as an open distributive rule ('may be taxed'), there is no clause that disallows the other Contracting State (i.e., the State that is neither residence State under Article 4(1)-(3) nor situs State, but may be the State of a secondary residence under Article 4(1) OECD and UN MC) from taxing such income. While this shows the importance of the 1977 reform of Article 6(1) OECD and UN MC, a way out under the 1963 wording might be a broad interpretation of Article 23 OECD and UN MC with a view to its object and purpose, viz. to apply this rule not only to the 'winner' or the tie break (Article 4(2) and (3) OECD and UN MC), but equally (like Article 1 OECD and UN MC) to the other residence State, even though it 'loses' the tie break. No difficulties arise where the immovable property is located in a third State. Like under the post-1977 OECD and UN MC, Articles 7 or 21 OECD and UN MC apply (*supra* m.nos 7 et seq and 21).

2. No Explicit Inclusion of Agriculture and Forestry

74 Another heritage of the pre-1977 OECD MC is that the **explicit reference** to agriculture and forestry is **missing**. As noted above (see *supra* m.no. 52 et seq.), however, this does not imply a difference in substance if at least the definition of 'immovable property' (usually, paragraph 2) refers to 'equipment used in agriculture and forestry' (see *infra* m.no. 107 et seq.). In these cases, the Article 6 OECD and UN MC-equivalent applies without any problems. In particular, there is no need to consider whether there is a PE.

75 This interpretation does not work for older DTCs that do not include an **expansive list of immovable property** (including agriculture and forestry) in their Article 6(2). Thus, any income that would have fallen under such Article 6 only because of the explicit mentioning of 'equipment used in agriculture and forestry' in the Article 6(2) OECD and UN MC-equivalent (example: interest income; see *infra* m.no. 108), will be covered by the Articles 7, 10, 11, 12, or 21 OECD and UN MC-equivalents instead, as the case may be. However, Article 6 OECD and UN MC-equivalent will not apply to these side payments.

76 A distinction is required for **core income** from agriculture and forestry. If the DTC contains neither an Article 6(2) OECD and UN MC equivalent nor an Article 6(4) OECD and UN MC equivalent but at least a norm corresponding to Article 5 OECD and UN MC, establishing that typical facilities of agricultural and forestry enterprises constitute a PE (for these clauses, cf. *supra* Article 5 at m.no. 169), income from agriculture and forestry will fall under Articles 7, 10, 11, 12, or 21 OECD and UN MC, as appropriate. If the DTC does not contain an Article 6(2) OECD and UN MC equivalent but at least a rule corresponding to Article 6(4) OECD and UN MC that includes 'business profits' into the scope of application of Article 6 OECD and UN MC (see *infra* m.no. 240 et seq.), then any income which is directly connected with the soil (e.g., income from crops or severed trees, income from letting fields and forests) would still fall under the Article 6 OECD and UN MC norm.

3. Inclusion of Fishery

77 In turn, some countries tend to include not only agriculture and forestry but also **'fishery'** or **'freshwater fishery'** into the parenthetical text of their Article 6(1) OECD and UN MC-equivalent. Examples can be found in the treaty practice of Bangladesh, New Zealand and Turkey. Such extension constitutes a substantial departure from the OECD MC which cannot be interpreted as including income from fishing activities in the scope of 'immovable property' under its Articles 6(1) and (2) OECD and UN MC-equivalent (see *supra* m.no. 55 and *infra* m.no. 198).

4. Inclusion of Income from Shares in Immovable Property Companies

78 A **significant number** of countries, including Finland and the Baltic States, tend to **include** any actual or notional income that the **shareholder** of a **real estate company** obtains from her right based in company law to use the immovable property that belongs to the company into the scope of Article 6 (for details, see *infra* m.no. 229 et seq.).

5. 'Real' Instead of 'Immovable' Property

79 US law generally uses the term **'real property'** to mean '[l]and and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land'.[27] Thus, **Article 6 US MC** uses that term in lieu of 'immovable property' used in Article 6 OECD and UN MC.

80 The US MC 1996 actually equated the terms, including parenthetical references to the OECD and UN MC term 'immovable property': Article 6 US MC 2006 was entitled 'Real Property (Immovable Property)', Article 6(1) US MC 1996 mentioned '[i]ncome ... from real property (immovable property)', and Article 6(2) US MC 1996 stated: 'The term "real property (immovable property)" shall have the meaning under the **law of the Contracting State** in which the property in question is located.' Moreover, no. 2 US MC 1996 Tech. Expl. to Article 6 stated that the two terms are synonymous.

81 Interestingly, the parenthetical references to immovable property were eliminated in Article 6 US MC 2006. Moreover, no. 2 of the 2006 Tech. Expl. to Article 6 US MC, which retained the first two sentences quoted above, deleted most part of the original language but at least confirmed that the expanded definition in Article 6(2), sentence 2 US MC conforms to that in the OECD and UN MC, but is **more limited** than the definition of **'real property'** for purposes of Article 13 (1) US MC which includes certain other interests in real property not covered by Article 6(2) US MC.

82 Notwithstanding the deletion of the parentheticals and the change to no. 2 Tech. Expl. to Article 6 US MC, there is no evidence to suggest that the changes were intended to modify the underlying understanding that the terms 'real property' and 'immovable property' remain **synonymous** and **interchangeable**. On the contrary, as the above-quoted explanation makes clear, the US understands the expanded US MC 2006 definition of 'real property' and the expanded OECD and UN MC definition of 'immovable property' to 'conform' to each other.

27. Black's Law Dictionary 8th edn (2008) at 1254. 'Real property can be either corporeal (soil and buildings) or incorporeal (easements)'.

http://www.pbookshop.com

case law[81] and legal scholarship[82] hold to the view that Article 9(1) OECD and UN MC prohibits adjustments that are not based on considerations concerning appropriateness of pricing but are instead based on formal grounds, for example, assuming hidden distributions because of a lack of clear and *a priori* agreements. Such case law and scholarship therefore reject the contrary position taken primarily by the German tax administration[83] which argues that Article 9(1) OECD and UN MC does not act as a restriction on a Contracting State's ability to make adjustments for reasons other than a lack of arm's length conditions between associated entities.

c. *Situations Outside the Scope of Article 9 OECD and UN MC*

16 The OECD and UN MC does not explicitly address transfer pricing adjustments foreseen in domestic law in **situations that otherwise fall outside the scope of Article 9(1) OECD and UN MC**. While there is broad consensus that the OECD MC does not restrict adjustments to transactions completely outside the *subjective* scope of Article 9 OECD and UN MC (e.g., where a **non-enterprise taxpayer,** such as a private individual, is involved),[84] it is unclear whether it nevertheless limits the rights of the Contracting States to allocate income outside the *relational* scope of Article 9 OECD and UN MC, i.e., with respect to situations between enterprises in cases where the **relationship is different from that described in Article 9(1) OECD and UN MC**, such as where commercial or contractual relationships or family bonds result in an interconnection of two enterprises (*infra* m.no. 50 et seq.). Two opposite approaches to this issue are possible: On the one hand, it is argued that transfer pricing adjustments between non-associated enterprises are either (1) **not authorized by Article 9(1) OECD and UN MC** and are therefore prohibited[85] or (2) should, at a minimum, conform

81. German *Bundesfinanzhof* of 11 October 2012, I R 75/11: 1959 DTC Germany/Netherlands; German FG Köln of 22 August 2007, 13 K 647/03, 56 *EFG* 161 (2008): DTC Germany/UK; German FG Hamburg of 31 October 2011, 6 K 179/10, 21 *IStR* 290 (2012): 1959 DTC Germany/Netherlands; left open by German *Bundesfinanzhof* of 9 November 2005, BFH I R 27/03, *BStBl. II* 564 (2006): 1925 DTC Germany/Italy.
82. See, e.g., Schnieder, E.-A., 8 *IStR* 65, 67-69 (1999); Becker, H., in: G/K/G, Art. 9 at m.no. 116; Kroppen, H.-K. & Rasch, S., 11 *ITPJ* 26, 28-29 (2004); Gosch, D., 'Wechselbezügliches zwischen internationalen und nationalen Gewinnkorrekturvorschriften', in: Carlé *et al.* (eds), *Gestaltung und Abwehr im Steuerrecht, Festschrift für Klaus Korn* (2005) at 391, 398-402; Eigelshoven, A., in: V&L, 5th edn (2008), Art. 9 at m.no. 27; Baumhoff, H. & Greinert, M., 17 *IStR* 353, 357-358 (2008); Schaumburg, H., *Internationales Steuerrecht*, 3rd edn (2010) at m.no. 16.293; Jacobs, O.H., *Internationale Unternehmensbesteuerung*, 7th edn (2011) at 759; for a different approach, see Wassermeyer, F., in: Wassermeyer, Art. 9 at m.no. 128. For a detailed discussion of the prevailing opinion and the contrary positions, see Wittendorff, J., *Transfer Pricing* (2010) at 227-230; Wittendorff, J., 17 *ITPJ* 200, 208-209 (2010).
83. See para. 1.4.1. of the German Administrative Principles of 23 February 1983, BMF IV C 5 – S 1341 – 4/83, *BStBl. I* 218 (1983), as amended by *BStBl. I* 1122 (1999).
84. See, e.g., Becker, H., in: G/K/G, Art. 9 at m.nos 96-99; Wassermeyer, F., in: Wassermeyer, Art. 9 at m.no. 79; Eigelshoven, A., in: V&L, 5th edn (2008), Art. 9 at m.no. 34; De Broe, L., *International Tax Planning and Prevention of Abuse* (2008) at 513-514; Schaumburg, H., *Internationales Steuerrecht*, 3rd edn (2010) at m.no. 16.293; Bullen, A., *Arm's Length Transaction Structures* (2011) at 73-74; Vögele, A. & Raab, J., in: Vögele *et al.* (eds), *Verrechnungspreise*, 3rd edn (2011) at m.no. B21.
85. Becker, H., in: G/K/G, Art. 9 at m.no. 90-92; Rotondaro, C., 10 *IStR* 769, 771 (2001); Becker, H., *IWB*, Fach 10 Gruppe 2, 1705, 1714-1715 (2003); Kroppen, H.-K. & Rasch, S., 11 *ITPJ* 26, 28 (2004); Eigelshoven, A., in: V&L, 5th edn (2008), Art. 9 at m.no. 38; De Broe, L., *International Tax Planning and Prevention of Abuse* (2008) at 514; see also Baker, Art. 9 at m.no. 9B.15 with note 5; for an overview of Danish, Norwegian and Swedish literature on this question, see Wittendorff, J., *Transfer Pricing* (2010) at 201-202.

with the arm's length standard;[86] this interpretation is, at least in part, based on the assumption that Article 9(1) OECD and UN MC is an exhaustive exception – rather than a mere supplement (*infra* m.no. 39) – to Article 7(1) OECD and UN MC, which grants exclusive taxing rights to the residence State.[87] On the other hand, it is argued that in situations outside the personal scope of Article 9(1) OECD and UN MC, a **DTC does not restrict the sovereign ability of a residence State to adjust profits** without regard to the arm's length standard so long as such adjustments remain within the limits of the anti-discrimination provisions of Article 24 OECD and UN MC;[88] hence, DTC provisions that impose adherence to the arm's length standard in situations arising outside the personal scope of Article 9(1) OECD and UN MC would be viewed as extending the restriction established in Article 9(1) OECD and UN MC to such situations.[89] While this latter position is certainly technically correct and is otherwise supported by the fact that the OECD and UN MC does not deal with economic double taxation comprehensively, it strongly implies that 'associated enterprises' within the meaning of Article 9(1) OECD and UN MC somehow enjoy more treaty protection than other, non-independent taxpayers.

5. Historical Background

The historical developments of Article 7 and of Article 9 OECD MC are closely related as both Articles address the same phenomenon: the **allocation of business income.** Article 9 OECD MC deals with transactions between associated, but separate, enterprises, while Article 7 OECD MC addresses the attribution of profits within a single enterprise.[90] 17

86. Eigelshoven, A., in: V&L, 5th edn (2008), Art. 9 at m.no. 39.
87. See for this argument, e.g., Becker, H., in: G/K/G, Art. 9 at m.nos 57-60; contra Wittendorff, J., *Transfer Pricing* (2010) at 179.
88. See, e.g., Wassermeyer, F., in: Wassermeyer, Art. 9 at m.nos 78-79; Chebounov, A., 11 *IStR* 586, 587-589 (2002); Gosch, D., 'Wechselbezügliches zwischen internationalen und nationalen Gewinnkorrekturvorschriften', in: Carlé *et al.* (eds), *Gestaltung und Abwehr im Steuerrecht, Festschrift für Klaus Korn* (2005) at 391, 396-397; Vann, R.J., 51 *BTR* 345, 372 (2006); Wittendorff, J., 63 *BIT* 107, 113-114 (2009); Wittendorff, J., *Transfer Pricing* (2010) at 199-202 (also discussing Danish, Norwegian and Swedish literature); Schaumburg, H., *Internationales Steuerrecht*, 3rd edn (2010) at m.no. 16.293; Bullen, A., *Arm's Length Transaction Structures* (2011) at 73-75; Fross, A., '53 *ET* 507, 511 (2013). See also para. 1.2.1. of the German Administrative Principles of 23 February 1983, BMF IV C 5 – S 1341 – 4/83, *BStBl. I* 218 (1983), as amended by *BStBl. I* 1122 (1999), noting that it would be contrary to the sense and purpose of a double taxation convention to prohibit, in certain cases, adjustments of income which are objectively necessary; this position is based on contributions by Debatin, H., 59 *DStZ/A* 388 (1971); 25 *DB* 2032 (1972); 60 *DStZ/A* 276 (1972), 21 *RIW/AWD* 596 (1975).
89. See, e.g., the second sentence of para. 7 of the Protocol on Art. 9 of the 2006 DTC Germany/US, stating that 'Article 9 shall not be construed to limit either Contracting State in allocating income between persons that are related other than by direct or indirect participation within the meaning of paragraph 1, such as by commercial or contractual relationships resulting in controlling influence, so long as such allocation is otherwise in accordance with the general principles of paragraph 1 of Article 9.' For the characterization of this clause as an extension of the arm's length principle, see Oestreicher, A., in: E/J/G/K, Art. 9 at m.no. 6. For the characterization of this clause as an exception to the prohibition of adjustments outside the scope of Art. 9(1), see, however, Eigelshoven, A., in: V&L, 5th edn (2008), Art. 9 at m.no. 146. See on this point also the US Tech. Expl. on Art. 9 of the 1989 DTC Germany/US, according to which this clause 'makes clear' that Art. 9 does not limit the rights of Contracting States in such cases.
90. For the Authorised OECD Approach ('AOA') under Art. 7 see the OECD MC Comm. on Art. 7, The *Report on the Attribution of Profits to Permanent Establishments* (approved by the CFA on 24 June 2008 and by the Council for publication on 17 July 2008) and the 2010 'sanitized' version of the *Report on the Attribution of Profits to Permanent Establishments* (approved by the CFA on 22 June 2010 and by the Council for publication on 22 July 2010).

http://www.pbookshop.com

a. Article 9 OECD MC

18 The **League of Nationals Draft of 1927** (1927 Draft LN MC)[91] dealt with double taxation of business income in its Article 5, which focused on the concept of 'permanent establishment' for the allocation of taxing rights. Influenced by German tax law under which subsidiaries were treated as branches for tax purposes (**'*Filialtheorie*'**),[92] that initial Article 5 regarded affiliated companies as PEs.[93] That approach was also embedded in the debate about the appropriate method for allocating profits to PEs,[94] but soon gave way to a different notion: Treating associated enterprises as separate entities (**'separate entity approach'**).[95] Thus, as early as in the **1928 LN Draft MC**,[96] it had become apparent that the term 'undertaking' (or 'enterprise') included, in the context of a corporation, only the corporate entity itself together with its branches (considered to form a part of that single corporate entity) and no longer included subsidiary corporations which are themselves separate legal entities.

Thereafter, the **separate accounting method** and the **arm's length principle**, both of which are fundamental ideas governing Article 9, were set out in the **1933 Carroll Report**:[97]

> Thus, instead of extending its operations into each country through a branch of its own organisation, the parent enterprise conducts its operations through a subsidiary, which, in law, is a separate legal entity. The parent must therefore, in strict law, deal with the subsidiary company as if it were a separate legal person. In other words, the legal transactions between the parent and the subsidiary should be conducted in the same manner as similar transactions between independent legal persons. As long as the inter-company transactions are carried on under the same circumstances and conditions and on the same terms as they would be between two entirely separate and independent persons, dealing with each other in an open market, and in a manner which is graphically described as at 'arm's length', the tax authorities in general respect the separate legal existence of the subsidiary company and tax it on the basis of its own declaration as supported by its properly kept separate accounts. To verify this

91. 'Draft of a Bilateral Convention for the Prevention of Double Taxation', Annex I to the Report on 'Double Taxation and Tax Evasion' presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations Document no. C.216.M.85.1927.II (1927).
92. See RFH of 30 January 1930, RFH I A 226/39, *RStBl.* 138 (1930) ('Shell decision'); RFH of 16 September 1930, RFH I A 129/30, *RStBl.* 757 (1930) ('Citroën decision'); cf. Wassermeyer, F., in: Wassermeyer, Art. 9 at m.no. 5, briefly explaining the subsequent developments in German case law and legislation.
93. Wittendorff, J., *Transfer Pricing* (2010) at 87.
94. The 1933 Carroll Report and the subsequent MCs strongly favoured separate accounting for PEs and affiliated enterprises, and argued that the method of fractional apportionment should only be applied as a last resort; see Carroll, M.B., 'Methods of allocating taxable income', *Taxation of Foreign and National Enterprises Vol. IV*, League of Nations Document no. C.425(b).M.217(b).1933.II.A. (1933) at paras 664-675; cf. Wittendorff, J., *Transfer Pricing* (2010) at 89-92. For a detailed overview of the historical discussion, see also Carroll, M.B., 34 *Colum. L. Rev.* 473 (1934), noting that in the 1933 Model 'the advocates of the method of separate accounting as the basic method for allocating taxable income have won a decided victory in the international sphere over the supporters of fractional apportionment'.
95. See Wittendorff, J., *Transfer Pricing* (2010) at 88.
96. See 'Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes', Annex I to the Report on 'Double Taxation and Tax Evasion' presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Document no. C.562.M.178.1928.II. (October 1928), where 'affiliated enterprises' were no longer deemed as PEs.
97. See Carroll, M.B., 'Methods of allocating taxable income', in: *Taxation of Foreign and National Enterprises Vol. IV*, League of Nations Document no. C.425(b).M.217(b).1933.II.A. (1933) at para. 384; see also Carroll, M.B., 29 *AJIL* 586, 588 (1935).

> declaration and accounts, the tax authorities may enquire into the current of business between the local subsidiary and the parent company or other subsidiary companies of the parent, which may for convenience be termed associated companies, and scrutinise carefully the results of interlocking transactions. If this is difficult, they may resort to a comparison with similar enterprises and make an empirical assessment upon the basis of turnover, or in accordance with one or another of the empirical methods described above in discussing the allocation of profits of local branches of foreign enterprises. Such is the situation in the great majority of countries.

19 Based on the 1933 Carroll Report, and by enhancing the 1928 LN Draft MC with language based on Article IV of the 1930 US/France DTC,[98] the **1933 LN Draft MC (Article 5)**[99] and the **1935 LN Draft MC (Article VI)**[100] each incorporated an identical provision which is substantively similar to Article 9(1).[101]

The same fundamental rules are found in **the Protocol to the 1943 Mexico MC (Article VII)**[102]**and the Protocol to the 1946 London MC (Article VII)**,[103] the former providing the basis for the UN MC and the latter for the OECD MC. In particular, Article VII of the Protocol to the 1946 London MC stated:[104]

> When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both

98. See Carroll, *id.* 29 *AJIL* 586, 592-593 (1935); cf. Wittendorff, J., *Transfer Pricing* (2010) at 93.
99. 'Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation', Annex to the 'Report to the Council on the Fourth Session of the Committee', League of Nations Document no. C.399.M.204.1933.II.A. [F./Fiscal. 76.] (June 1933); the draft convention is also reprinted as appendix to Carroll, M.B., 34 *Colum. L. Rev.* 473, 494-498 (1934); see also Avery Jones, J.F. *et al.*, 60 *BIT* 220, 244 (2006).
100. 'Revised Text of the Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation', Annex I to the 'Report to the Council on the Fifth Session of the Committee', League of Nations Document no. C.252.M.124.1935.II.A. [F./Fiscal 83] (1935).
101. Art. 5 1933 LN Draft MC and Art. VI 1935 LN Draft MC both read: 'When an enterprise of one Contracting State has a dominant participation in the management or capital of an enterprise of another Contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise'. In addition, the Comm. on Art. 5 of the 1933 LN Draft MC noted: 'Ad *Article 5.* – Article 5 deals with subsidiaries which will be taxed as independent enterprises provided no profits or losses are transferred as a result of the relations between the affiliated companies. If such transfers are effected, the administration will make the necessary adjustments in the balance-sheets'. See the Annex to the 'Report to the Council on the Fourth Session of the Committee', League of Nations Document no. C.399.M.204.1933.II.A. [F./Fiscal. 76.] (1933) at 7. The term 'arm's length' was explicitly mentioned in Art. 3 of the 1933 LN Draft MC concerning PEs: 'The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length'.
102. 'Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion', League of Nations Document no. C.2.M.2.1945.II.A (July 1943).
103. 'London Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property', annex to 'Report on the Tenth Session of the Committee', League of Nations Document no. C.37.M.37.1946.II.A (April 1946).
104. The 1943 Mexico MC contained the same language but added that the entering into the accounts of the former enterprise is 'subject to the rights of appeal allowed under the laws of the State of such enterprise'.

http://www.pbookshop.com

enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise.

Moreover, in addressing the concept of PEs, **Article V(8) of each of the above-referenced protocols** contained the following clause (initially espoused in Article 3(a) of the Protocol to the 1930 US/France DTC[105] and now found in Article 5(7) OECD MC):

> The fact that a parent company, the fiscal domicile of which is one of the contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State, regardless of the fiscal obligations of the subsidiary toward the State in which it is situated.

That clause reflected, and appears to have been based upon, the following conclusions set forth in the **1933 Carroll Report**:[106]

> In short, the very fact that a subsidiary company is formed to operate an establishment of any kind within a country gives rise to the necessity of carrying on business subject to the same legal requirements as any other corporate entity within the country. The subsidiary must ordinarily have an adequate capital, and the nature of its activities and its contractual relations with outsiders and other corporate units of the enterprise will determine its income. If its income is diverted to other units of the enterprise in any manner, the tax authorities, as a general rule, have only to examine the inter-company transactions, appraise their terms and results in the light of sound legal and business principles, or by comparison with independent companies engaged in similar activities under similar circumstances, and recapture any profit that may be shown to have been diverted. Obviously, if the diverted profit is retrieved after it has already been taxed as income of another unit, double taxation will result, unless the administration of the other country is willing to reduce its assessment and refund a proportionate amount of the tax. … As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.

Moreover, the **Comm. on Article V(8) of each of the above-referenced Protocols** noted:[107]

> Paragraph 8 of Article V of the Protocol refers to subsidiary companies. It states that a subsidiary cannot be regarded as a permanent establishment of the parent enterprise. This provision has two main effects. In the first place, the country where the subsidiary is situated is not entitled to tax the parent company except, of course, on the dividends which the parent company may receive from its subsidiary, in accordance with the [dividends provisions of the applicable MC Article]. Secondly, in taxing the parent company, the authorities of the country in which such company is situated may not take into account the actual profits made by the subsidiary company in the other country, but only the dividends and other income paid by the subsidiary to the parent company. These rules follow the principle that a subsidiary constitutes a distinct legal entity and should therefore be taxed separately. At the same time, Article VII of the Protocol indicates the criteria according to which the correctness of the mutual relations between parent and subsidiary companies can be checked so as to avoid abuses resulting in the diversion of profits or losses from one company to the other.

20 The concepts and underlying reasoning of Article V(8) of those two Protocols were, without any intention of substantively changing them,[108] incorporated into the draft Article on PEs in the **1958 OEEC Report.**[109] Thereafter, the **1960 OEEC Report** proposed a new Article XVI on associated enterprises while noting that the 'expression "enterprise of a Contracting State" means an enterprise carried on by a resident of the Contracting State concerned'.[110] Both provisions were subsequently incorporated, unchanged, first into the OECD MC 1963 as **Articles 5(6) and Article 9**, and from there taken over into the OECD MC 1977.[111] In the **OECD MC 1977 Comm. on Article 9** it was furthermore clarified that such allocation of income should be made by using the **arm's length principle.**[112] While Article 9 OECD MC 1963 did not address corresponding adjustments,[113] discussions within the OECD[114] led to the inclusion of the **new Article 9(2) in the OECD MC 1977**, which provides that double taxation should be avoided by the use of corresponding adjustments; however, a number of States entered reservations with respect to this new provision.[115]

105. See Carroll, M.B., 2 *Int'l L.* 692, 714-715 (1967-1968).
106. See Carroll, M.B., 'Methods of allocating taxable income', in: *Taxation of Foreign and National Enterprises Vol. IV*, League of Nations Document no. C.425(b).M.217(b).1933.II.A. (1933) at paras 672-673.
107. 'Commentary on the Model Bilateral Convention on the Prevention of the Double Taxation of Income and Property', in: 'London and Mexico Model Tax Conventions – Commentary and Text', League of Nations Document no. C. 88. M.88.1946. II.A. (1946), Series of League of Nations Publications 1946.II.A.7. (1946) at 17.
108. See the Third Report of the Fiscal Committee 'The elimination of double taxation' (1960; circulated within the OEEC under C(60)157) at para. 18.
109. Annex to the Report of the Fiscal Committee of the OEEC on 'The elimination of double taxation' (1958) at 34: 'The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.'
110. See Annex A to the Third Report of the Fiscal Committee 'The elimination of double taxation' (1960; circulated within the OEEC under C(60)157) at 24.
111. See Annex I ('Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital') to the Report of the Fiscal Committee on the Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital among the Member Countries of the OECD (1963), C(63)87 Part I, at 41 and 45.
112. See no. 1 OECD MC Comm. on Art. 9, which was subsequently shifted into no. 2 by the 1997 update (Report 'The 1997 Update to the Model Tax Convention', adopted by the Council of the OECD on 23 October 1997); see also Wittendorff, J., *Transfer Pricing* (2010) at 99.
113. Corresponding adjustments, however, were already foreseen for PEs in Art. VI(1)(B) of the Protocol to the 1946 London Model, which read: 'The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding section, rectify the accounts produced, especially to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length. If the accounts of the permanent establishment in one contracting State are rectified as a result of such verification, a corresponding rectification shall be made in the accounts of the establishment in the other contracting State with which the dealings in question have been effected.'
114. See, e.g., FC/WP 7 on 'Apportionment of Profits', FC/WP7(70)1 (1970), FC/WP 7 on 'Corresponding Adjustments', FC/WP7(70)2 (1970), and notably the proposed 'Amendments to Article 9 of the OECD Draft Convention and the Commentaries thereon' by FC/WP 7 on 'Apportionment of Profits', FC/WP 7(71)1 (1970); for a historical overview see also Solilová, V. & Steindl, M., 67 *BIT* 128, 130-131 (2013).
115. See Wittendorff, J., *Transfer Pricing* (2010) at 99.

http://www.ibookshop.com

purchasing option is used. This rather short rule of thumb leaves room open for the differing national delimitations – which most probably was intended in finding a compromise in the working group.

97 **US:** Revenue Ruling 55-540 of 1995: Indicators of a conditional sale: a) Parts of the payment are attributed to an equity of the lessee; b) the lessee is contractually obliged to an amount of 'rental' payments that also lead to the acquisition of the title; c) the 'leasing rates' are so high at the beginning that they constitute an inordinately large proportion of the amount needed to secure the acquisition; d) 'rental' payments materially exceed the current fair rental value and thus compensate for more than just the use of property; e) the price for a purchase is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or a relatively small amount in comparison to the total payments under the contract up to that point; and f) some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

98 **Belgium:** The *Hof van Cassatie/Cour de Cassation* ruled that the reference to national law in the method Article does not only encompass the details and technicalities of granting the credit for source taxation, but also allows the State of Residence to recharacterize the payment[101] – a remarkable but hardly maintainable inversion of the 'new approach' interpretation of Article 23 OECD and UN MC (see no. 32.6 et seq. OECD MC Comm. on Article 23). Thus, in the court's decision, a contract that was classified as an operating lease under Article 12 OECD and UN MC by the source State, was reclassified as a financial arrangement such that the payments qualified as interest under Article 11 OECD and UN MC.

99 **Germany:** For personality: German BMF of 19 April 1971, BStBl. I, 264 et seq. (1971); for real property: *Id.* of 21 March 1972, BStBl. I, 188 et seq. (1972).

e. *Demarcation to Services*

100 All possible modes of Article 12 OECD and UN MC (use/information/alienation) transfer the IP, at least temporally, to the payer for its own use. Such modes must be distinguished from

- Contracts in which the IP is not transferred to the payer, but is kept and used by the payee for producing goods or rendering services to the payer (*infra* m.no. 101 et seq.);
- Contracts in which the payee never owns the IP, but rather the IP is owned by the payer, as research contract situations (*infra* m.no. 108).

101 *aa. Use of IP by the Beneficial Owner for Rendering Services.* The modes of Article 12 OECD and UN MC (use/information/alienation) have to be delimitated to contracts where the **IP is not transferred to the payer**, but retained and used by the beneficial owner for producing goods or rendering services to the payer.[102] In that case, the IP is only a means of production for the entrepreneurial activity of the payee and thus Article 7 applies instead of Article 12 OECD and UN MC. A further criterion for the delimitation is the **risk of the exploitation and liabilities for the use**. If the beneficial owner retains the risk of the exploitation of his IP or is liable for the use of the IP, Article 12 does not apply, but, instead, Article 7 OECD and UN MC.[103]

102 The OECD Model Comm. provides examples for such services at m.no. 11.4. After-sales services and services rendered by a seller to the purchaser under a warranty are accessory to

101. Belgian *Hof van Cassatie/Cour de Cassation* of 22 January 2010, F.08.0100.F, *ING Lease Belgium*, IBFD Tax Treaty Case Law, on the 1975 DTC between Belgium and Czech Republic.
102. Chinese SAT circular 507 (2009) according to Cai & Hong, 16 *APTB* 297 (2010).
103. Wassermeyer, F., in: Wassermeyer, Art. 12 at m.no. 10.

the main product and service, and thus commonly do not include a separate transfer of IP.[104] In case they do, the transfer of IP is often ancillary under the mixed contracts principle (*infra* m.no. 163 et seq.) For technical assistance, see *infra* m.no. 179 et seq. A list of potential customers developed specifically for the payer out of generally available information contains no protected IP from the start. Opinions given by an engineer, an advocate or an accountant are good examples of consulting services[105] (*infra* m.no. 103). The electronic provision of advice or communication is not a compelling indicator of a lack of IP transfer. A trouble-shooting database and non-confidential information in response to frequently asked questions or common problems are examples of applied consulting, but not the transfer of know-how as such.

103 **Consulting** has to be distinguished from transmitting information about experience (know-how). The consultant does not transmit the experience knowledge itself, but uses it as his 'means of production' for giving advice to the customer in a specific situation.[106] If the consultant disclosed his experience knowledge to his customers, he would risk going out of business in the long run, as he could only serve them once with original knowledge. Furthermore, much of the experience is also gained by consulting other customers, but the specific knowledge about them is typically protected by professional secrecy. A further criterion is that of liability: A consultant is typically liable for his advice, especially if it is appropriate for the situation of the customer and is realizable. The vendor of know-how as such is not liable for the realization of the experience knowledge – he only sells the tool not the solution, while the consultant sells the solution, not his tools. Therefore, income from consulting has to be taxed according to Article 7 OECD and UN MC.[107] For the divergent treaty practice to include technical assistance in Article 12, see *infra* m.no. 179.

104 Spanish courts often do not distinguish between the provision of services and the transmission of know-how.[108]

105 *bb. Use of Equipment for Rendering Services.* A parallel problem arises regarding the use of industrial, commercial and scientific equipment. To **differentiate equipment rental from the provision of services**, the use or the right to use of the equipment has to be fully transferred to the payer. If the owner of the equipment stays in control of it, he merely provides services with the equipment. The OECD Technical Advisory Group in e-commerce developed some helpful indicators that suggest an equipment lease based on section 7701(e) IRC in the context of computer equipment:[109]

a) the customer is in physical possession of the property;
b) the customer controls the property;
c) the customer has a significant economic or possessory interest in the property;
d) the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract;
e) the provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and
f) the total payment does not substantially exceed the rental value of the [computer] equipment for the contract period.

104. See also Chinese SAT circular 507 (2009) according to Cai & Hong, 16 *APTB* 297 (2010); Indian High Court of Calcutta of 23 February 1994, No. 257 of 1986, Nos 468 and 469 of 1985, *Hindusthan Paper Corp. Ltd.*, IBFD Tax Treaty Case Law, para. 12. et seq., Baker Art. 12 at m.no. 12B.15.
105. See also Chinese SAT circular 507 (2009) according to Cai & Hong, 16 *APTB* 297 (2010).
106. German BFH of 16 December 1970, I R 44/67, *BStBl. II* 235, 237 (1971), see also Baker, Art. 12 at m.no. 12B.13.
107. Wassermeyer, F., in: Wassermeyer, Art. 12 at m.no. 10.
108. See García Heredia, A., 45 *ET* 103, 108 et seq. (2005).
109. OECD, TAG on treaty characterization issues arising from E-Commerce, 05.02.2001, DAFFE/CFA(2001)12 at m.no. 28.

http://www.pbookshop.com

106 **'Transponder leasing'**: Satellites bear transponders that have a certain transmission capacity. In rare cases, whole satellites are rented out and can be controlled by the payer; thus, leading to a use of equipment (no. 9.1 OECD MC Comm. on Article 12).[110] However, in most cases, only transmission capacity is rented out, while the satellite as a whole stays in the control of its owner. Thus, there is no right to use of the equipment as such. The owner of the satellite just uses it to perform a service to the payer (i.e., the provision of transmission capacity).[111] The same analysis applies to **cable** and **pipeline leasing** (no. 9.1 OECD MC Comm. on Article 12, as well as **'roaming agreements'**: The foreign cell phone provider does not rent out transmission infrastructure to the home provider of the customer, but just provides him the service of transmitting the data through his own network (no. 9.2 OECD MC Comm. on Article 12). **International Private Leased Circuits** (IPLC) generally only provide abstract bandwidth and thus qualify as a service; equipment installed at the customer's premises to enable access to this bandwidth normally has an ancillary nature and can be disregarded under the mixed contract principles[112] (*infra* m.no. 163 et seq.).

107 **Cloud computing,** 'software as a service' and 'infrastructure as a service' contracts that provide 'server time', 'CPU time' on supercomputers and abstract data storage amounts generally qualify as service contracts. Contracts that include **specific servers**, storage mediums or other equipment that can be **physically accessed and individually and exclusively controlled** by the customer, typically qualify as a lease of equipment under the criteria listed above.[113] The 2014 OECD BEPS report on the digital economy overstates the alleged lack of guidance regarding cloud computing,[114] probably reflecting an invigorated revenue interest of the source States.

108 **Container leasing** poses a parallel problem. Worldwide container circulation is designed to efficiently allocate and use containers, which allows carriers to pick up and leave containers where needed. Thus, the primary function of container leasing enterprises can be described as performing clearing services to balance worldwide supply and demand for containers.[115] Hence, a lease of specific containers can be seen rather as an instrument to achieve that service, less an ultimate end in itself.[116] Thus, Article 12 OECD and UN MC was not seen as applicable under a 'functional approach' by a minority opinion in the 1983 OECD Report on Container Leasing. But even in the case of contractual arrangements that only provide for provision and removal of containers without regard to specific ones, the lessee still obtains physical possession and control of the containers (eventually delegated to carriers). Thus, Article 12 UN MC applies. The assessment changes, however, if the control of the container remains with the lessor. In that case, the lessor provides freight forwarding or transportation services under Articles 8 or 7 OECD and UN MC, to which the lease would be ancillary and disregarded, *infra* m.no. 163 et seq. For special clauses on container leasing, see *infra* m.no. 195.

109 *cc. Contracting: Creation of IP for a Principal.* Contractual arrangements on the creation of IP often provide from the start that the creator shall not acquire the copyright, but, instead, the principal does. IP law might also provide for such a result: For example, US law applies

110. See also Barret, 65 *BIT* 17 (2011).
111. See also, *id.* at 17; other opinion, arguing with the use of a process, Indian ITAT of 16 October 2009, Nos 5385 to 5387/Del/2004; ITA Nos 2623 & 2624/Del/2008, *New Skies Satellites N.V.*, IBFD Tax Treaty Case Law;1988 DTC between India and the Netherlands.
112. Other opinion Indian High Court Verizon Communications Singapore Pte Ltd v. ITO (2013), cited after Sheht/Takkar, 68 *BIT* 213 (2014): 1994 DTC between India and Singapore.
113. Indian ITAT of 31 January 2008, 2008-21 SOT 152, *Millennium Infocom Technologies Ltd.*, at m.no. 8.4; Spanish Central Economic-Administrative Court of 28 February 2008, 4085/2005, IBFD Tax Treaty Case Law: 1990 DTC between Spain and the US.
114. OECD, Addressing the Tax Challenges of the Digital Economy (2014) at 132 et seq.
115. OECD, 'The Taxation of Income Derived from the leasing of containers', 12 *Intertax* 149, 157 et seq., m.no. 40 et seq. (1984).
116. *Id.*

work-for-hire rules to independent contractors in certain cases.[117] In all these cases, however, the payments are not for the developed IP, but for the service of developing IP.[118] Thus, Article 12 OECD and UN MC does not apply (no. 8.1 OECD MC Comm. on Article 12), but Article 7 OECD and UN MC (no. 10.2 OECD MC Comm. on Article 12) or Article 17 OECD and UN MC will. If instead of the principal, the contractor acquires the IP, it has to be differentiated. The remuneration for developing the IP still has to be qualified under Article 7 or 17 OECD and UN MC, as Article 1 OECD and UN MC relates only to IP that has come to existence and not to its creation (no. 10.2 OECD MC Comm. on Article 12). Further remuneration for the use of the IP by the principal of its creation falls under Article 12 OECD and UN MC. In the probable case of a mixed contract (creation and later use of IP), the principles for mixed contracts apply (*infra* m.no. 163). As neither the creation nor the subsequent use of the IP can be regarded as ancillary, the remuneration has to be split.

110 The OECD MC Comm. gives the example of an artist contracted for a **sound recording** (no. 18 OECD MC Comm. on Article 12):

> Where, however, the copyright in a sound recording, because of either the relevant copyright law or the terms of contract, belongs to a person with whom the artist has contractually agreed to provide his services (*i.e.* a musical performance during the recording), or to a third party, the payments made under such a contract fall under Articles 7 (*e.g.*, if the performance takes place outside the State of source of the payment) or 17 rather than under this article, even if these payments are contingent on the sale of the recordings.

This applicable analysis has also been confirmed in case law – the *Boulez* case.[119] The same standard applies to **movie shootings**: The actors can be subject to source taxation on their salary under Article 15 OECD and UN MC, but their remuneration cannot be construed as partly a royalty under Article 12 OECD and UN MC.[120] **Journalists** may be employed or contracted for writing specific articles, but freelancers might also produce work on their own and try to have it published afterwards, leading to royalty payments.[121] If the terms of a **website development** contract attribute the copyright to the customer, the development constitutes a service.[122] A further prominent example is **contract research**: The scientists are employed or contracted for certain research and in return the research findings and their exploitation are assigned to the principal. There typically cannot be construed a transfer of a plan or know-how in the narrow or wide sense from the agent to the principal in advance of the principals' registration of a patent or design.[123] Such an assessment is only possible in exceptional and well-founded cases, where there is in substance no principal-agent relationship and thus no contracting. This is the case if the contractor is not assigned specific research tasks and is not controlled in his research by the customer, so that he researches independently in substance.

117. 17 U.S.C. § 101.
118. Lokken, 36 *TLR* 269 (1981) on US domestic law.
119. US Tax Court of 16 October 1984, 12705-79, *Boulez v. Commissioner*, 83 T.C. 584 (1984), see also Baker, Art. 12 at m.no. 12 B.14.
120. Austrian BMF of 2 March 2007, EAS 2825. For German domestic law: German BFH of 20. January 1972, BFH IV R 1/69, *BStBl. II* 214 (1972); German BFH of 31 May 1972, BFH I R 94/69, *BStBl. II* 697 (1972).
121. German BMF of 13 March 1998, IV B 4-S 2303-28/98, *BStBl. I* 351 (1998).
122. Bobbett & Avery Jones, 60 *BIT* 24 (2006) with reference to *Boulez v. Commissioner*, 83 US Tax Court 584 (1984) and *Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932).
123. Apparently other opinion, Chinese SAT circular 507 (2009) according to Cai & Hong, 16 *APTB* 297 (2010).

http://www.ebookshop.com

111 Payments under **cost contribution agreements (CCAs)/cost sharing agreements** are typically not the consideration for the use of IP.[124] CCAs are concluded between different companies to finance common research and development. The member companies reimburse the costs of R&D to an entity that coordinates the contract research and registers the acquired IP. In return, the member companies can access and use the common IP pool free of charge. Even though the coordinating entity is the formal owner of the IP, all members of the CCA are its beneficial owners. Thus, the expense reimbursement is not a payment for the use of existing IP, but payments to facilitate current common contract research. The assessment changes if there is no ongoing research and no plans for research in the foreseeable future. In this case, future contributions have to be qualified in substance as consideration for the use of the pooled IP. Remuneration paid to the coordinating entity for the coordination services has to be separated as business income under Article 7 OECD and UN MC or – depending on the wording – as 'technical assistance' under Article 12 OECD and UN MC (*infra* m.no. 179 et seq.)

112 Dependent employees normally do not receive a property interest for their inventions made during their work (**'work for hire'**). In some domestic laws employees are entitled by law to receive an adequate compensation (**employee inventors' compensation**), even if the research is part of their employment contract.[125] For the delimitation to Article 15 OECD and UN MC, see *supra* at m.no. 23.

5. The Object: Catalogue of (Intellectual) Property

a. Main Features, System and Boundaries

113 An exhaustive catalogue of the possible objects of use or information is found at the end of paragraph 2. The objects are designated in private IP law terms or with reference to them. The OECD MC Comm. describes the catalogue generally as containing (no. 8 OECD MC Comm. on Article 12):

– rights or property constituting the different forms of literary and artistic property;
– the elements of intellectual property specified in the text; and
– information concerning industrial, commercial or scientific experience.

The catalogue is conclusive. As the wording of the OECD MC Comm. points out, only the 'elements of intellectual property specified in the text' are protected (no. 8 OECD MC Comm. on Article 12). The OECD MC Comm. does not include a remark on the exhaustiveness of the definition like in Article 11 m.no. 21;[126] instead, this remark merely points to the fully autonomous definition of interest in Article 11 OECD and UN MC. Article 12 OECD and UN MC catalogues the covered types of IP autonomously, but not the scope of the different types of IP. Even though the catalogue encompasses almost all types of IP rights, some are not mentioned and thus **not included**. **Personality rights,** including the simple right to a name, are not included in the catalogue, except to the extent the different forms of copyright include them (for divergent country practice, see *infra* m.no. 176). Registration of a **domain name** does not constitute, as such, protected IP under the catalogue.[127] It may be seen as a 'like

124. Indian ITAT of 17 July 2013, 416/Mum/2008, *DDIT v. Marriott International Licensing Company BV*, 98 DTR 27 para. 14: 1988 DTC between India and the Netherlands; Indian ITAT of 15 March 2010, No. 834 of 2009, *ABB Limited*, IBFD Tax Treaty Case Law: 1994 DTC between India and Switzerland.
125. E.g., under the German *Arbeitnehmererfindungsgesetz*.
126. As pointed out by Baker, Art. 12 at m.no. 12B.06.
127. Bobbett & Avery Jones, 60 *BIT* 24 (2006).

right', see *infra* m.no. 196. **Spectrum/frequency licenses** relate neither to IP (no. 9.3 OECD MC Comm. on Article 12) nor to equipment (UN MC).[128]

114 The different IP items are arranged after their **degree of legal protection**:[129]

– The classical IP property interests (copyrights, patents, trademarks).
– Minor exclusion rights (designs, models, plans).
– Business secrets (secret formulae or processes) that enjoy basic legal protection, at least under competition law (know-how in a narrow sense).
– Unpublished, undivulged knowledge (experience), that is not secret and not legally protected (know-how in a wide sense).

As the first three groups are legally protected and give rise to a property interest or other forms of protection against third persons, 'their use and or the right to their use' can be subject to a contract. In contrast, the unprotected experience knowledge can only be disclosed once without being able to be taken back and thus grants no property interest (see in detail at m.no. 87). Baker concludes that the quality of being a property interest is generally not needed for Article 12 OECD and UN MC.[130] However, this disregards the differentiation between the first three groups that are associated with 'for the use or right to use' and experience knowledge that is just provided as such. If the twin wording 'use or right to use' (*supra* m.no. 82) was meant to cover also non-property interest items, it would have also been connected with the last item, experience knowledge. No sufficient legal protection is given in the case of pure **contractual positions**. While simple experience knowledge or other information can be made available under contractual terms that might give injunctive relief against the contract partner in the case of misuse, there is no property interest and no protection against third parties. **Transfer payments** for sportspersons only relate to the release certificate as a contractual position not covered by the catalogue of IP and equipment.[131] Furthermore, this contractual position is not rented out, but alienated.[132]

115 Another differentiation can be made between legal and descriptive items:

– Legal references to primary IP rights: copyrights, patents, trademarks;
– Descriptive reference
  – to protected 'sui generis' rights: designs, models, plans, secret formulae or processes
  – to unprotected information: experience knowledge.

The use of descriptive items does not dispense with the need for legal protection. Thus, for example, unprotected plans are not covered by Article 12 OECD and UN MC (*infra* m.no. 145). The descriptive nature of 'design' allows the inclusion of special semiconductor design rights (*infra* m.no. 144).

116 The UN MC and the OECD MC before 1992 also add as a non-IP item:

– Tangible goods: industrial, commercial or scientific equipment.

The equipment is arranged in the UN MC between the secret formulae or processes and the experience, as its ownership is legally protected and thus its use or right to use can be subject to a contract.

117 The MCs do not contain autonomous definitions of the different property rights. There is also no reference to the source State as in Article 10(3) OECD and UN MC. Thus, according

128. Barret, 65 *BIT* 17 (2011).
129. Pöllath, R. & Lohbeck, A., in: V&L, 5th edn (2008), Art. 12 at m.no. 60.
130. Baker, Art. 12 at m.no. 12B.11.
131. Haase & Brändel, *IWB* 798 (2010); Schlotter & Degenhart, 20 *IStR* 457 (2011), who point out that the German Tax Administration seems to qualify payments under Art. 12; Gosch, D., in: Kirchhof (ed.), *EStG*, 12th edn (2013), § 49 at m.no. 49 e.
132. Bozza-Bodden, N., in: S&D, Art. 12 at m.no. 107; see also German BFH of 27 May 2009, BFH I R 86/07, *BStBl. II* 120 (2010) for the loan of sportsmen.

http://www.pbookshop.com

that need to be present in order to determine that there is an employment relationship.[223] Accordingly, how each State interprets these control tests could vary significantly.

140 The OECD MC Comm. is unclear as to what happens if half of the factors indicate an employment agreement with the enterprise receiving the services and the other half point to employment with the formal employer. There are **no tiebreaker rules**. Thus, in the event of disagreement, it would be for the States to agree within the scope of the MAP how to compare and account for the various factors.

141 Similarly, the possibility of having **two concurrent employment relationships**, as for example, where the employee working in the State of work is spending half of his time for services for the employer in the residence State and the other half for the employer in the State of work (resulting in proportioning the remuneration) is not discussed. Arguments have been made that the reference to 'an employer' in Article 15(2)(b) OECD and UN MC clearly envisages the possibility of dual employment.[224] Therefore, it is possible that an employee could split his duties among several employers, whether related or not. The Comm. does not take a clear position on this issue; it only recognizes that a formal employment relationship may not reflect an actual employment relationship, in which event it needs to be determined whether or not the formal relationship should be set aside (no. 8.1 et seq. OECD MC Comm. on Article 15). All the examples focus on finding a single employer (see, e.g., nos 8.20 and 8.21 OECD MC Comm. on Article 15, Example 3), which has led to suggestions that perhaps the position of the Comm. is that there can only be one employer.[225] Such approach would be contrary to the clear wording of 'an employer' under Article 15(2)(b) OECD and UN MC, as well as not reflecting the economic reality of the situations where there are several genuine employment relationships. Therefore, it would be advisable to clarify this provision in the Comm. in order to avoid yet another issue that would be up to the States to agree within the scope of the MAP.

142 There is only one example in the Comm. where the factors of the control test were examined, notably Example 5 (nos 8.24 and 8.25 OECD MC Comm. on Article 15). Here, merely two of eight control test factors (combined with the failed 'nature of services' test) were sufficient to be able to attribute the employment relationship to the service recipient. Those two factors were **direct supervision and control**, and who bears the cost of remuneration. Additional examples would be helpful.

143 *ee. Presumptions and Deemed Employment.* Certain States have adopted **presumptions of 'employment'** that are designed to target employment relationships that are disguised as independent services to enjoy a lower tax burden. For example, in accordance with the Dutch Flexibility and Security Act 1999, there is a mandatory presumption whereby employment contracts exist when work has been carried out for another person in return for pay on a weekly basis, or at least for 20 hours per month during three consecutive months.[226] Belgium has a rebuttable presumption which treats commercial sales representatives as employees, and

223. See, e.g., Tax Court of Canada (Employment Insurance) of 4 March 2010, *Coloniale Maid Service Ltd. v. Minister of National Revenue*, 2010 *TCC* 115, [2010] 4 CTC 2218, where the court stated that the level of control is always a central question. However, the provision of equipment or helpers, degree of financial risk and an opportunity to profit should also be considered. The court quoted a prior case of the Supreme Court of Canada of 19 June 2001, 671122 *Ontario Ltd. v. Sagaz Industries Canada, Inc.*, 2 *SCR* 983, where the Court had stated that there is no *set* formula, rather the factors constitute a non-exhaustive list and a relative weight of each will depend on the particular facts and circumstances. See also: Supiot, A., 'Wage Employment and Self Employment' at 136.
224. De Broe, L. *et al.*, 54 *BIFD* 503, 512 (2000); Hinnekens, L., '(Part II)', 10 *Intertax* 325 (1988).
225. See: Pötgens, F., 61 *BIT* 476, 479 and 482 (2007); De Broe, L. *et al.*, 54 *BIFD* 503, 509 (2000).
226. See Commission of the European Communities, *Green Paper for Modernizing Labor Law to Meet Challenges of the 21st Century* (22 November 2006), 708 COM 11 (2006).

an irrebuttable presumption that treats company directors as self-employed.[227] In addition, Belgium requires that attorneys working for law firms are treated as independent contractors[228] even though the facts might indicate an employment relationship.[229] Austria requires that foreign and local professors are considered as employees rather than independent contractors.[230] Similarly, Austrian domestic law treats as employment income the payments for services to managers who are not characterized as 'substantial' shareholders, whereas the payments to managers who are characterized as 'substantial shareholders' are treated as income from independent services.[231]

144 As a result of these presumptions, the **formal agreement** might indeed differ from the actual relationship. If the other Contracting State follows the **substance-over-form approach**, double taxation or non-taxation is a likely result. For example, assume that an attorney practising law as an employee of a law firm resident of a State that gives relief by way of exemption is temporarily working in Belgium and the law firm does not have a PE in Belgium. If Belgium treats such an attorney as self-employed (with no PE in the country), whereas the residence Sate treats it as employment, double non-taxation may arise (see also *supra* m.no. 112).

145 A number of countries have developed rules to **target abusive strategies** where the employment income is converted into royalties.[232]

146 To the extent that such domestic law presumptions impact the outcome of taxation under the treaties that were **signed before** the presumptions became effective, the context of the treaty (or the good faith principle of Articles 26, 27 and 31 VCLT) may require that the presumptions are not applied. See the Dutch example discussed *supra* m.no. 106.

147 This is one of the reasons why the interpretation of the term 'employment' in accordance with **domestic law** of a State of work is **criticized.**[233]

148 *ff. International Hiring Out of Labour (IHOL).* Previously, the provisions dealing with the examination of the formal employment relationship were primarily focused on dealing with abusive transactions known as **IHOL**, which referred to the making available of temporary workforce in the State of work by **labour agencies** based in the residence State of the employee with which the employees enters into a formal employment agreement (no. 8 2008 OECD MC Comm. on Article 15). Before 2010, no. 8 of the OECD MC Comm. specifically stated that IHOL is an abusive strategy, whereby:

227. Engels, C., 'Subordinate Employees or Self-Employed Workers', in: Blanpain *et al.* (eds), *Comparative Labor Law and Industrial Relations in Industrialized Market Economies* (2004) at 275-291.
228. Arts 437 and 444 of the Belgian Judicial Code require that attorneys exercise their judgement independently and therefore cannot be under an authority of a third party.
229. Engels, C., 'Subordinate Employees or Self-Employed Workers', in: Blanpain *et al.* (eds), *Comparative Labor Law and Industrial Relations in Industrialized Market Economies* (2004) at 283.
230. Heinrich, J. & Moritz, H., 40 *ET* 149, 150 (2000), citing a 1997 regulation on treatment of persons teaching in Austrian universities, *Verordnung BGBl. II* 287 (1997); Gassner, W. & Lang, M., 'Double Non-Taxation of a Belgian Tax Law Professor Lecturing in Vienna?', in: Vanistendael (ed.), *Liber Amicorum Luc Hinnekens* (2002) at 219-230.
231. Pezzato, G., 'The Meaning of the Term "Employment" Under Article 15 of the OECD Model Convention', in: Hohenwarter-Mayr & Metzler, *Taxation Of Employment Income In International Tax Law* (2009) at 53.
232. Spain has special rules for salary paid in the form of royalties for the use of the right of image; a strategy often engaged by artists and sportsmen. The Netherlands may treat certain royalties from copyright received by an employee as a salary, where they would not have been received but for the employment relationship. Sweden has a rule of reclassifying royalties as employment income if they are derived from employment. See: Moessner, J.M., *Taxation of Workers in Europe* at 27.
233. Austrian scholars believe that this is one of the reasons why the undefined terms should be interpreted in their context, unless they are explicitly defined in the treaty or there is an explicit reference to the domestic law. Heinrich, J. & Moritz, H., 40 *ET* 149 (2000).

http://www.pbookshop.com

II. Article 15(1) OECD and UN MC: The Second Rule

1. Rule

156 '[U]nless the **employment is exercised** in the **other Contracting State**. If the employment is so exercised, such **remuneration** as is **derived therefrom may be taxed in that other State.**'

2. Unless the Employment Is Exercised

157 As an exception to the first rule, the right to tax is conferred on the other State if, and to the extent that, the **employment is exercised in such other State**. No, 1 OECD MC Comm. on Article 15 refers to taxation according to the place of actual exercise of the employment as 'the general rule' in cross-border employment situations. The test of actual exercise of the employment functions both as a threshold condition for the right to tax and as a criterion for the allocation of the remuneration.[245] The key expression 'exercise of employment', however, is not defined in the OECD and UN MC. The present author refers to Rust (*supra* Introduction at m.no. 61 et seq.) for the general methods of interpretation of an undefined term. With regard to the meaning of 'exercise', the OECD MC Comm. clarifies that employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid (no. 1 OECD MC Comm. on Article 15).[246] Following questionable **case law** of the Belgian Supreme Court on the interpretation of the 1970 DTC between Belgium and Luxembourg (see *infra* m.no. 324), both countries signed a protocol in 2002 to make it expressly clear that 'exercise of employment' refers to the State where the employee is physically present when carrying on his duties.[247] Since then, Belgium has signed similar protocols with a number of countries.[248] One consequence of this would be that a resident of a Contracting State who derives remuneration in respect of an employment from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State (no. 1 OECD MC Comm. on Article 15). The relevant criterion for the second rule of Article 15(1) OECD and UN MC should be where the employee is physically present when performing the services for which he is remunerated, rather than where the results of the employee's work are exploited.[249]

158 We face a problem of text and context if we try to assimilate the expression 'exercise of employment in the other State' in Article 15(1) OECD and UN MCand in the first sentence of Article 15(2) OECD and UN MC with that of mere **physical 'presence' or 'stay of the employee'** in the other State in Article 15(2)(a) OECD and UN MC. Different expressions are thus used in the same Article 15 OECD and UN MC. The expression of Article 15(2)(a) OECD and UN MC seems to refer to physical presence as a result of the exercise of employment (see *infra* m.no. 182). This does not mean, however, that the meaning of the expression used in Article 15(1) OECD and UN MC and the first sentence of Article 15(2) OECD and UN MC is fully and sufficiently explained by and borrowed from that of the

245. Hinnekens, L., '(Part I)', 8-9 *Intertax* 233 (1988).
246. Prokisch refers to 'personally' present, Vogel, 3rd edn., Art. 15 at m.no. 17 et seq.
247. On the interpretative value of the Prot., see De Broe, L., 'L'Usage du Commentaire OCDE et Autres Instruments Extrinsèques pour l'Interprétation des Conventions de Double Imposition Belges' at 455 et seq.
248. Para. 2 Prot. 1987 DTC between Belgium and the UK, para. 2 Prot. 2006 DTC between Belgium and the US.
249. Pötgens, F., *Income from International Private Employment (2007)* at 303.

expression in Article 15(2)(a) OECD and UN MC.[250] For purposes of Article 15(1) OECD and UN MC and the first sentence of Article 15(2) OECD and UN MC everything functionally connected with the activity exercised at the place of work should be included in that activity.[251] In other words, everything related to a certain activity should count towards that activity when assessing the physical presence required to be 'exercising' an employment for purposes of Article 15(1) OECD and UN MC and the first sentence of Article 15(2) OECD and UN MC. This principle differs from that applied when calculating the length of a stay under the 183-day clause (see *infra* m.no. 182 et seq.).

159 For ease of reference, the additional issues that might arise in interpreting 'exercise' when exceptional remuneration is granted for an abstention from work were discussed in the **previous section** (see *supra* m.no. 37 et seq.).

3. Such Remuneration as Is Derived Therefrom

160 The expression **'derived'** is used in the first rule ('salaries, wages and other similar remuneration derived by a resident … in respect of an employment') as well as in the second rule ('if the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State'). The first rule (and the wording used) seems to be mainly intended to bring income components into the sphere of Article 15 OECD and UN MC or the following articles. The second rule's object concerns the allocation of the income (after it has passed the first rule) to an employment exercised in the State of work.[252]

161 The OECD and UN MC do not as such define the term 'derived'. We refer back to the methods of interpretation discussed above (see *supra* m.no. 35 et seq.). According to Wattel & Mares, the terms **'paid' and 'derived'** as used in Articles 6-20 OECD and UN MC may include **every actual advantage**, i.e., every increase in wealth and every shift or increase in property, including non-realized capital gains (but not fictitious earnings and fictitious capital increases).[253] There are indeed arguments to be made for a broad interpretation of the term 'derived'. For the application of a tax treaty it is irrelevant when income from employment is paid (no. 2.2 OECD MC Comm. on Article 15). We can add that it should also be irrelevant where the employee's place of residence is at the time of payment. What matters is whether the income accrues to the employee in respect of the period of employment that he spent in the State of work. However, the allocation causes specific difficulties if the remuneration attributed to the employee is deferred (see *infra* m.no. 166 et seq.).

162 Methods for allocating the income to the employment exercised in the State of work may differ considerably. As a general rule, a pro rata breakdown of the salary between the residence State and the State of work(s) seems the most appropriate (so-called **'time proportionate method'**). However, in certain situations, deviations from this rule can be made. This will be the case when, e.g., the level of work in the two States is substantially different or if the salary level in the various States is substantially different or if it is clear that the income component relates solely to the employment exercised in one (of the) State(s). In general, if a more accurate allocation of the compensation can be made in respect of the duties performed in the relevant countries, the time-proportionate method should not necessarily stand as a **mandatory rule.** If the tax authorities of the State of work wish to tax a larger part of the salary than the pro rata share they will bear the burden of proof. If, on the other hand, the taxpayer asks for greater relief from double taxation in his residence State, the burden of proof to deviate from the pro rata share in this case will fall on the taxpayer.[254] Under the

250. Hinnekens, L., '(Part I)', 8-9 *Intertax* 229, 235 (1988).
251. Vogel, 3rd edn., Art. 15 at m.no. 18 et seq.
252. Pötgens, F., *Income from International Private Employment (2007)* at 349.
253. Wattel, P.J. & Mares, O., 43 *ET* 66, 67 (2003).
254. Peeters, B., 'Income from employment', in: Van De Vijver (ed.), *The New US-Belgium Double Tax Treaty* (2009) at 309.

http://www.bookshop.com

exercising an employment can tax the income derived from that activity, regardless of the year in which the remuneration is awarded/paid or received.[269]

169 This decision is in line with the OECD MC Comm. according to which the condition provided by Article 15 OECD MC for taxation by the State of work is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies **regardless of when** that income is paid to, credited to or otherwise definitively acquired by the employee (no. 2.2 OECD MC Comm. on Article 15).

170 According to the OECD MC Comm. On Art. 15 (no. 2.11) following the 2013 OECD *Discussion Draft on Termination Payments* where deferred remuneration can be associated to a **specific period of past employment** in a given State, it should be considered to be derived from that State.[270] The German *Finanzgericht Köln* dealt with such a situation.[271] The taxpayer, a resident of Germany, worked in Hungary for a Hungarian subsidiary of a German parent. He received a remuneration from the Hungarian company, but also from the parent company. Because 20 per cent of the latter remuneration benefited the German company, the parent company withheld German wage tax on 20 per cent of the remuneration and 80 per cent of the payments were charged to the subsidiary and taxed in Hungary. The taxpayer also received payment of his yearly share in the company's profits, but he renounced this payment in 1999 and had the corresponding amount credited to the working-time account scheme of the German company that was intended to be used for early retirement. In mid-2001, the taxpayer changed employer and the amount credited to the working-time account was paid out to him. According to the German tax authorities the total amount was taxable in Germany as it qualified as 'Other income' under Article 21 of the 1977 DTC between Germany and Hungary. According to the taxpayer only 20 per cent of the amount was taxable in Germany, as it was a deferred payment for employment exercised in Hungary. The *Finanzgericht Köln* ruled that the payment was covered by Article 15(1) of the 1977 DTC between Germany and Hungary as there was a connection between the work exercised and the payment. The amount of 80 per cent of the payments was therefore exempt from German taxation under Article 23(1) of the 1977 DTC between Germany and Hungary. It also held that the payment had to be considered a deferred compensation for work exercised in earlier years. Finally, the court held that the fact that the taxpayer lived and worked in Germany when the payment was made is not relevant when he received the payment. What mattered was that the payment was earned for an activity exercised in Hungary.

171 A case of the Swiss *Bundesgericht* deals with the allocation of a bonus under the 1977 DTC between the UK and Switzerland.[272] The taxpayer, a British citizen, was a resident in the canton of Zurich from 1 July 1995 to 31 July 1996. He was vice-director of a Swiss company and worked in Zurich during that time. On 31 July 1996 he returned to London where he worked for another company. In March 1997, he received a bonus from the Swiss company for the financial year of 1996. The court noted that the **bonus** was paid when the taxpayer was already a resident of the United Kingdom. The court held, however, that the bonus was paid in respect of work previously performed in Switzerland and thus concluded that Switzerland had the right to tax.

172 According to Pötgens, a continued service bonus should be **allocated** to the services rendered in the **period between** the conditional grant and the condition(s) being fulfilled.[273] The present author agrees. This is also the view taken in the US Technical Explanation: A

269. Further discussed by De Broe, L. & Van Bortel, D., 2 *TRV* 131-132 (2010).
270. OECD, *Tax Treaty Treatment of Termination Payments, Discussion Draft*, 25 June to 13 September 2013, nos 28-29.
271. German *Finanzgericht Köln* of 11 September 2008, 10 K 1133/05, 29, *EFG* 29 (2009), *DStRE* 278 (2009).
272. Swiss *Bundesgericht* of 15 February 2001, *StRev.* 409 (2001) and *RDAF II* 19 (2002); see also Moessner, H.J., 'General Report', 85b *CDFI* 73, 105 (2000); Hildebrandt, M.W., 'Switzerland', 85b *CDFI* 766 (2000); Walden, D., 'United Kingdom', 85b *CDFI* 785 (2000).
273. Pötgens, F., *Income from International Private Employment (2007)*at 407.

bonus paid to a resident of a Contracting State with respect to services performed in the other Contracting State with respect to a particular taxable year would be subject to Article 14 for that year even if it was paid after the close of the year.[274]

173 The general principle adopted by the UK in taxing deferred remuneration awarded to an employee before he becomes a UK resident but received after arrival in the UK, is that no UK tax will be charged upon receipt. The converse is applied to a departing employee. The UK will assert taxing rights on deferred remuneration when received wherever the employee **resides at that time**.[275]

174 In *Garcia v. The Queen* the taxpayer moved to Canada after having worked in the US for approximately nine years. The taxpayer received a bonus while living in Canada in respect of his employment exercised the previous year in the US. The court concluded that the employment bonus is **taxable at the time of receipt**, regardless of when or where the employment to which it relates was exercised. According to the court, Article XV of the 1980 DTC between the US and Canada assigns jurisdiction to tax that income to Canada. If the employment was exercised in the US, the US also has jurisdiction to tax, should it choose to do so. If the income is taxed in both States, the taxpayer would receive a credit under the DTC and (Canadian) domestic law.[276] The present author cannot agree with the conclusion the Canadian Tax Court reached in this case, which denies the position set forth in the OECD MC Comm. (no. 2.2 OECD MC Comm. on Article 15, to which Canada did not record an observation) and in the US MC Technical Explanation (see also *supra* m.no. 81).[277]

5. May

175 Contrary to the first rule, the second rule does not offer exclusive allocation of tax jurisdiction and should be read and applied in conjunction with that of Article 23 OECD and UN MC. The residence State must allow relief by means of either the exemption with **progression or the credit method** (Articles 23A/B OECD and UN MC).[278] Note that the 1964 DTC between France and Belgium (pre-OECD MC) deviates from common OECD practice and confers exclusive taxing rights to the State of work.

176 If Contracting States want to exclude cases of double non-taxation, they will have to **mutually oblige themselves** in their treaties to tax a certain situation in any event in one of the two States. However, this is not standard treaty practice. According to the credit method, the right to tax remains with the residence State, which is merely obliged to credit the tax levied in the source State. Therefore, should the State of work refrain from imposing taxes, the commitment of the residence State to credit the foreign tax is to no avail. This ensures that single taxation is achieved.[279] Article 17(2)(d) of the 1975 DTC between the US and Israel and Article 16(2)(d) of the 1980 DTC between the US and Egypt contain an additional condition for exemption in the State of work (i.e., that the remuneration is subject to tax in the residence State).[280]

177 If the residence State relieves double taxation by the exemption method such an exemption applies, as a rule, irrespective of whether the remuneration is taxable according to the laws

274. 2006 US MC Tech. Expl. Art. 14 § 231.
275. Walden, D., 'United Kingdom', 85b *CDFI* 785 (2000).
276. Tax Court of Canada of 28 September 2007, *Garcia v. The Queen*, 2007 CarswellNat 3129, 2007 TCC 548, 2007 DTC 1593.
277. 2006 US MC Tech. Expl. Art. 14 § 231.
278. Hinnekens, L., '(Part I)', 8-9 *Intertax* 229, 236 (1988).
279. Lang, M., 'General Report', 89a *CDFI* 86 (2004).
280. Art. 17(2)(d) 1975 DTC between the US and Israel reads as follows: '2. Remuneration described in paragraph 1 derived by an individual who is a resident of one of the Contracting States shall be exempt from tax by the other Contracting State if: (d) the remuneration is subject to tax in the first-mentioned Contracting State.'

http://www.pbookshop.com

on Article 15), the countries that applied the 'duration of activity' test agreed to adopt the 'physical presence' test in their practice.[294] Now, the 'physical presence' test is applied uniformly (except for France, see *infra* m.no. 224), unless the treaty itself calls for the 'duration of activity' test (see, e.g., 1971 DTC between Austria and Belgium, 1967 DTC between Belgium and Germany, 2006 DTC between Austria and the Czech Republic; see also m.nos 219-231). With regard to treaties that were entered into prior to 1992 by the countries that followed the 'duration of activity' test, the 'physical presence' test is nevertheless applied, unless the treaty itself calls for 'duration of activity' test. (See *infra* discussion re Belgium (m.no. 219), France (m.no. 224), Germany (see *infra* m.no. 225) and the Netherlands (m.no. 227).

187 **'Is present'** has to be **interpreted autonomously and literally**. There is no link with 'place of habitual abode' under Article 4 OECD and UN MC or national law. Until 1996, 'is present' was interpreted by Germany in the same way as 'abode'.[295] On 10 July 1996, the German Tax Court distinguished between 'abode' and 'presence' and reverted to the interpretation in line with the OECD MC.[296] The court held that the term 'present' ('*sich aufhalten*') as used in the treaty had to be understood in terms of physical presence as evidenced by the English version of the OECD MC. The Dutch *Hoge Raad* decided that Article 3(2) of the 1990 DTC between the Netherlands and Brazil and of the 1991 DTC between the Netherlands and Nigeria could not be applied to interpret the term 'present' in accordance with Dutch domestic law as that term was not used in a similar context in any provision of Dutch tax law. The Court concluded that under Articles 31 and 32 VCLT, the term should get its ordinary meaning in its context. According to the Court, the ordinary meaning is the period of physical presence in the State of work.[297]

c. Period or Periods

188 All possible periods of 12 consecutive months must be considered, even if periods overlap (no. 4 OECD MC Comm. on Article 15). Presence for a number of **short periods is aggregated**. (Article 15(2)(a) OECD and UN MC refers to 'period' or 'periods'). That applies also if the employee's activities were exercised for more than one employer.[298]

d. Day

189 The OECD MC Comm. requires counting all days that the taxpayer is present, including 'part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the

294. See: Pötgens, F., *Income from International Private Employment (2007)* at 540, citing for Germany: German *BMF* of 5 January 1994, *BStBl.* I 11 para. 2 (1994), amended by *BMF* of 5 July 1995, *BStBl.* I 373 (1995) and *BMF* of 20 April 2000, *BStBl.* I 483 (2000); for Austria: Austrian *BMF* of 18 November 1991, AOFV 331/1991; for Belgium: Circular of 25 May 2005, AFZ 2005/0652 (AFZ 08/2005) and for France: *Bulletin Officiel des Impôts*, 14 B-3-03, no. 92 of 22 May 2003, pt 118 (confirming the application of the 'days of physical presence' method re 1999 DTC Algeria/France).
295. German BFH of 10 May 1989, I R 50/85, *BStBl. II* 75 (1989): 1959 DTC between Germany and the Netherlands, where a taxpayer did not have a habitual abode in Germany because he returned to his home outside of Germany every night.
296. German BFH of 10 July 1996, I R 4/96, *BStBl. II* 15 (1997): DTC between Germany and the Netherlands.
297. Dutch *Hoge Raad* of 21 February 2003, nos 37011 and 7004, *BNB* 2003/177 and 178.
298. Kempermann, M., in: Flick/Wassermeyer/Kempermann, Art. 15 at Anm. 42, but different view by Wassermeyer, F., in: Wassermeyer at 612.

exemption) and death or sickness in the family' (no. 5 OECD MC Comm. on Article 15). **No overnight stay is required** in order for the day to count towards 183 days.[299] Notional vacation days (unused vacation days earned in the course of employment in the State of work) do not count as a day as only actual physical presence days are considered.[300]

190 Note further that some older DTCs that generally call for a 'duration of activity' test may also include days that are spent outside of the State of work (e.g., '**normal breaks in work**', 'normal **holidays**'). For further discussion, see *infra* m.no. 219 on Belgium and m.no. 225 on Germany.

191 The **maximum length of a 'short break'** is not defined, while Germany considers 14 days,[301] Belgium looks at 2-3 days and requires them to be between two subsequent employment agreements.[302] In the 1991 report, the OECD puts 2-3 days in parenthesis following the term 'short breaks', thus arguably defining a short break as 2-3 days.[303]

192 Neither the 'day' nor the length of a 'day' is defined by the OECD MC Comm. Since paragraph 5 of the OCED MC Comm. includes any 'part of day', it is not so relevant to determine whether the 'day' should be interpreted as a '**calendar day**' or '**24 hour period**'.[304] Only a few minutes spent in the State of work would cause the whole day to be included.[305] Some argue that this is not a desirable consequence of Article 15(2) OECD and UN MC because it shifts a right to tax to a State where the employee spends just one hour a day per 183-day period (184 work days of 1 hour give the taxing rights to the State of work, whereas 23 work days of 8 hours (184 total work hours) do not). Consequently, it has been suggested that the 'day' needs to be defined by **imposing minimum time (in hours)**.[306] While it would be fair to treat the same 183 work hours in the same way (whether they are structured as full-time work days of 8 hours or as separate 183 1-hour work days), current Comm. does not support this approach. No. 5 OECD MC Comm. on Article 15 emphasizes that the 'physical presence' test is straightforward and can be documented relatively easy. If the minimum hour test is adopted, it may create an administrative burden, as well as abuse opportunities (e.g., structuring work days shorter than eight hours).

193 The following exceptions apply:

1) presence in State of work while in **transit** (no. 5 OECD MC Comm. on Article 15);
2) days when the taxpayer was a **resident of the State of work** (no. 5.1 OECD MC Comm. on Article 15);
3) any **entire day spent outside** the State of work (no. 5 OECD MC Comm. on Article 15);
4) **days of sickness** that **prevented** the individual from **leaving the State** of work and he would have otherwise qualified for the exemption; and, in some cases;
5) **holidays before or after the employment**.

194 (1) 'In transit'. The term refers to a **trip between two points outside of the State of work** (no. 5 OECD MC Comm. on Article 15). Maximum time (hours or days) that could be spent 'in transit' is not defined in the OECD MC Comm. Austrian and Belgian tax authorities

299. Pötgens, F., *Income from International Private Employment (2007)* at 503.
300. Belgian Court of Appeals Brussels of 14 June 2000, 197 *TFR* 258: 1964 DTC Belgium/France.
301. Wassermeyer, F., in: Wassermeyer, Art. 15 MA at para. 103; Kiel Tax Authorities, 20 September 1978, *FR* 536 (1978).
302. Circular of 25 May 2005, AFZ 2005/0652 (AFZ 08/2005), point 4.1.3.
303. See OECD, 'The 183 Day Rule' at para. 12(h).
304. On possible interpretations of a 'day', see Pötgens, F., *Income from International Private Employment (2007)* at 509 et seq.
305. No. 5 OECD MC Comm. on Art. 15 states that 'a day during any part of which, however brief, the taxpayer is present in a State counts as a day'; see also: German BFH of 10 July 1996, *BStBl. II* 15 (1997); Pötgens, F., *id.* at 513.
306. Pötgens, F., *id.* at 511-518 (2007); Grotherr, S. *et al.*, *Internationales Steuerrecht* at 560.

http://www.pbookshop.com

consider 24 hours as maximum.[307] Some legal scholars believe that the day cannot count as 'in transit' if the employee provides services in the State of work during that day.[308] 'In transit' would also not apply to employees engaged in the international transport industry such as truck drivers and employees in international rail transport. Since truck drivers actually 'work' in each State they cross en route to their destination State, such presence in the traversed States does not count as 'in transit'.[309] No. 10 OECD MC Comm. on Article 15 states that special rules related to truck drivers are to be negotiated by the States when concluding DTC.

195 (2) 'Days when the taxpayer was a resident of the State of work': The wording is identical in UN MC Article 15(2)(b). The US MC Article 14.2.a) differs only in that it refers to the '**taxable year**' instead of '**fiscal year** concerned'.

196 While this exception was added in paragraph 1 OECD MC 2008 Comm., some countries applied the exception **prior** to this.[310] Indeed, some **included** the days of residence in the calculation (e.g., Germany and Switzerland).[311] Note that the current **UN MC Comm.** does **not refer** to the **residence exception**.

197 (3) 'Entire day spent outside of a State'. Since the 'physical presence' test does **not require** the presence for the **purposes of an employment activity**, similarly, days absent from the State of work, even if related to the employment activity (such as a business trip), will be excluded (no. 5 OECD MC Comm. on Article 15).[312]

198 (4) 'Days of sickness that prevented the leave'. Days of **sickness** do not count only if the employee would **have left otherwise**.[313] The taxpayer should be prepared to present some evidence to substantiate his position (e.g., purchased flight tickets).

199 (5) 'Holidays before or after the Employment'. Paragraph 5 OECD MC Comm. on Article 15 requires that '**holidays before, during or after activity**' are included in the 183-day count, as long as the taxpayer is present in the State of work.

200 The question may be asked if it is correct to include holidays spent in the State of work if such **holidays** have no connection with the employment (e.g., such holidays were taken before the individual was even aware of any employment opportunities in the State of work or considerably after the employment was terminated). For example, assume that an individual goes for a skiing vacation in Switzerland in the winter and later that year gets a job offer in Switzerland. Or, if a person takes an extended vacation in Italy for six months, runs out of money and takes a temporary job for a few weeks. Assuming that the 183-day threshold would be exceeded in both scenarios, one must ask whether there is a **sufficient economic link** between the individual and the State of work for the State of work to retain the taxing rights.

201 However, the term '**before, during and after** the activity' is **not defined** in the OECD MC Comm., leaving some room for argument that the holidays that are not right 'before, during

307. Resolution of the Austrian tax authorities from 18 November 1991, AOFV 331; Circular of the Belgian tax authorities of 25 May 2005, AFZ 2005/0652 (AFZ 08/2005) at 4.1.3.
308. Pötgens, F., *Income from International Private Employment (2007)* at 533; Pijl, H., 6124 *WFR* 1561 (1994).
309. Pötgens, F., *id.* at 538; Kempermann, M., in: Flick/Wassermeyer/Kemperman, at para. 40.1.
310. See, e.g., Netherlands: Dutch *Hoge Raad* of 15 September 1999, *BNB* 1999/420; Belgium: Circular AFZ 2005/0652 (AFZ 08/2005) of 25 May 2005; Baeten, J., 11 *Revue Générale de Fiscalité* 3, 7 (2005); Peeters, B., *TRV* 230 (2006); Austria: Lechner, E. & Muszynska, K., 'Die 183-Tage-Regel im DBA-Recht', in: Gassner et al., *Arbeitnehmer im Recht der Doppelbesteuerungsabkommen*, at 159 and 160; Canada: *Daniel G. Erwin v. Her Majesty The Queen*, 21 August 1997, Case 97-43(IT) I, published in 1997 *CarswellNat* 230098 D.T.C. 1330 [1998] 2 CTC 2112; 1980 DTC Canada/United States.
311. See, e.g., Germany: Tax Authorities, Draft Resolution of 3 November 2005 (Entwurf BMF-Schreiben) at pt 4.2.1; Switzerland: Swiss *Verwaltungsgericht Zürich* of 20 October 2004, Case SB.2003.00074, *StE* 2005 A 32, Nr. 61977: DTC Switzerland/UK.
312. See also Kempermann, M., in: Flick/Wassermeyer/Kempermann, at para. 40.
313. Pötgens, F., *Income from International Private Employment (2007)* at 527.

and after the activity' should be excluded from the 183-day threshold.[314] Another argument can be made that since the taxpayer is allowed to exclude his presence due to sickness that prevented the leave, the taxpayer should also be allowed to exclude holidays spent in the State of work before or after the employment, if the taxpayer can prove that the holidays bear no link to the employment.[315] Indeed, Germany has stated that the holidays count only if they **immediately precede or follow the employment** (see *infra* m.no. 226). Austria is on the other end of the spectrum, counting all holidays.[316]

202 Note further that paragraph 2 **US** MC Technical Explanation specifically excludes vacation days before or after the employment if they are shown to be independent of the presence for employment purposes. The OECD MC Comm. had a similar provision from 1992 to 1995, which was criticized and subsequently deleted.[317] This deletion signals that the Comm. takes a **very strict position** that any holidays spent in the State of work during the reference period have to be included in the 183-day count, whether or not they are immediately before or after the employment. This is in line with the OECD's current approach that any day spent in the State of work is counted, save for limited exceptions allowed by the Comm.

203 While such approach is based on the simplicity of the test (no. 5 OECD MC Comm. on Article 15), one must ask whether such approach is correct in all situations where the presence in the State of work bears no relation to the employment. In addition to holidays that are not related to the employment, discussed above, one may ask, whether the days prior or after the employment must be counted; for example, where (1) the individual is present in the State of work in another capacity (such as a **director, researcher or student**); (2) a non-working spouse that accompanies the working spouse to a State of work later gains an employment and (3) the individual is treated in a medical facility of the State of work before or after the employment because the individual has chosen that particular facility (the disease does not prevent the employee from leaving the country). As it stands at the moment, the Comm. clearly requires that all of these days of presence be counted. Perhaps a better approach would be to create a rebuttable presumption that such days are normally considered to be included, unless the taxpayer can substantiate, to the satisfaction of the tax authorities, that these days were not related to the employment.[318]

e. '183 Days'

204 If a taxpayer's presence in the State of work does not exceed 183 days, the State of work does not have a right to tax, even if (1) the taxpayer worked **exclusively** in the State of work[319] and (2) employment of **more than one year** does not result in **presence** of more than 183 days in any year (often occurs in industries where working periods are concentrated, e.g., **oil and gas industry**).[320]

314. *Id.* at 529.
315. Arnold, B.J., 62 *BIT* 224, 226 (2008).
316. Aumayr, E., 'The 183-day-rule in the OECD Model Convention', in: Hohenwarter-Mayr & Metzler (eds), *Taxation of Employment Income In International Tax Law* (2009) at 109-124.
317. Pötgens, F., *Income from International Private Employment* (2007) at 523.
318. Pötgens, F., *id.* at 525 has a similar suggestion with regard to the holidays that were spent in the State of Work considerably before or after the commencement of the employment activities.
319. Dutch Court of Appeal Amsterdam of 7 July 1982, Case no. 1193/81, *V-N* 1984/2018: 1967 DTC between the Netherlands and the UK.
320. OECD, 'The 183 Day Rule' at para. 19.

(eds), *A Tax Globalist: Essays in Honour of Maarten J. Ellis*, 210 (2005); De Broe, L. & Neyt, R., 'Tax Treatment of Cross-Border Pensions under the OECD Model and EU Law', 63 *BIT* 86 (2009); Dietvorst, G., 'Proposal for a Pension Model with a Compensating Layer', 16 *EC Tax Review* 142 (2007); Dommes, S., *Pensionen im Recht der Doppelbesteuerungsabkommen* (2012); Fiszer, J. & Sajkiewicz, M., 'Voluntary Individual Retirement Accounts in Poland: General Overview and Tax Aspects', 50 *ET* 47 (2010); Gassner, W. & Konezny, G., 'Leistungen von Pensionskassen im DBA-Recht', in: Gassner, Lang, Lechner, Schuch & Staringer (eds), *Arbeitnehmer im Recht der Doppelbesteuerungsabkommen*, 311 (2003); Günkel, M., 'Die Besteuerung von Abfindungen an beschränkt Steuerpflichtige', 18 *IStR* 889 (2009); Haase, F., *Außensteuergesetz – Doppelbesteuerungsabkommen*, Art. 18 (2009); Hall, N., 'UK-US Competent Authority Agreement in Respect of Pension Schemes', 7 *Derivs. & Fin. Instrums.* 303 (2005); Hellerstein, W. & Smith, J.C., 'State Taxation of Nonresidents' Pension Income', 56 *Tax Notes* 221 (1992); Ismer, R., in: V&L, 5th edn, (2008), Art.18; *id.*, 'Ruhegehälter nach Art. 18 OECD-MA: Grundlagen und aktuelle Entwicklungen', 20 *IStR* 577 (2011); Jirousek, H., 'Neues Doppelbesteuerungsabkommen Österreich-Rumänien', 16 *SWI* 106 (2006); Kavelaars, P., 'Cross-Border Aspects of Pensions in the Netherlands, Including Tax Treaty and EU Law', 61 *BIT* 86 (2007); Kemmeren, E., 'Pensions (Article 18 OECD Model Convention)', in: Lang, Pistone, Schuch & Staringer (eds), *Source versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, 279 (2008); Kolb, A., Lang, M., Loukota, H., Waldburger, R., Waters, M. & Wolff, U., 'Employment Income under Tax Treaty Law – Case Studies', 12 *SWI* 522 (2002); Lang, M., 'Art. 19(2) – The Complexity of the Model Can Be Reduced', 61 *BIT* 17 (2007); *id.*, 'Public Sector Pensions and Tax Treaty Law', in: Gutman (ed.) *Liber Amicorum in Honour of Cyrille David* 223 (2005); *id.* 'Ruhegehälter nach Art. 19 Abs. 2 OECD-MA', in: *Steuerzentrierte Rechtsberatung, Festschrift für Harald Schaumburg* 879 (2009); Law, S.B., 'Pensions and Social Security Payments in Recent Tax Treaties', 65 *BIT* 123 (2011); Neves, T.C., 'Portuguese Taxation of Inward Expatriates and Pensioners: A Sunny Welcome', 50 *ET* 220 (2010); OECD, 'The Tax Treatment of Employee's Contributions to Foreign Pension Schemes', in: OECD (ed.), *Model Tax Convention: Four Related Studies*, 4 *Issues in International Taxation* 43 (1992); Otto, K., 'Der Irrgarten der betrieblichen Altersversorgung und die Förderung der Entgeltumwandlung', in: Mellinghoff, R. (ed.), *Steuern im Sozialstaat*, 29 DStJG 325 (2006); Pötgens, F.P.G., *Income from International Private Employment: An Analysis of Article 15 of the OECD Model* (2007); *id.*, 'The Closed System of the Provisions on Income from Employment in the OECD Model', 41 *ET* 252 (2001); *id.*, 'The Relationship between Preservative Tax Assessments and Netherlands Tax Treaties: Not Always *Pacta Sunt Servanda*?', 50 *ET* 183 (2010); Reich, M., 'Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis', in: Peter, Bernard & Peter (eds), *Internationales Steuerrecht in der Schweiz. Aktuelle Situation und Perspektiven* 185 (2005); Reimer, E., *Der Ort des Unterlassens* (2004); Strunk-zur Heide, T., in: S/K/K Art. 18; Toifl, G., 'Pensionen im DBA-Recht', in: Gassner, Lang, Lechner, Schuch & Staringer (eds), *Arbeitnehmer im Recht der Doppelbesteuerungsabkommen*, 287-310 (2003); Vock, M.E., 'Employee Stock Options under DTC Law', in: Hohenwarter & Metzler (eds), *Taxation of Employment Income in International Tax Law* (2009); Wassermeyer, F., in: Wassermeyer, Art. 18 OECD-MC; Waters, M., 'Employment Income under Tax Treaty Law-Case Law', 12 *SWI* 522 (2002); Wattel, P.J. & Marres, O., 'Characterization of Fictitious Income under OECD-Patterned Tax Treaties', 43 *ET* 66 (2003); World Bank, *Averting the Old Age Crisis* (1994); Yoo, K. & De Serres, A., 'Tax Treatment of Private Pension Savings in OCDE Countries', 39 *OECD Economic Studies* 73 (2004).

A. General Issues

I. Overview and Main Features

1. Main Features of Article 18 OECD MC and Articles 18A, 18B UN MC

2 Article 18 OECD and UN MC deals with **pensions and other similar remuneration from past employment**. Pensions from previous independent services are not covered by the provision. The **OECD MC** gives exclusive right to tax to the residence State. In contrast, the **UN MC** contains two alternative versions, both of which establish exclusive source State taxation for payments made by a public scheme that is part of the social security system. Article 18B UN MC also permits (unlimited and non-exclusive) taxation by the non-residence State if the payment is made by a resident of that other State or a PE situated therein.

3 Article 18 OECD MC and Articles 18A(1) and 18B(1) UN MC are limited to **employment-related pensions**. This has to be seen against the background that pensions can come from three different sources: (i) A statutory social security system guaranteeing at least basic income; (ii) occupational pensions and (iii) individual and voluntary provision (no. 10 OECD MC Comm. on Article 18).[1] Article 18 OECD MC and Articles 18A (1) and 18B (1) UN MC definitively apply to the second pillar, both to pensions from funded and unfunded schemes as well as to defined benefit and defined contribution pensions. Coverage of the first pillar (social security) under the OECD MC depends on its exact design, whereas the UN MC contains a special clause for social security systems in any case. The third pillar is generally excluded for lack of relation to employment.

4 The provisions have as their object the **taxation of pensions only**. They deal neither with the tax treatment of contributions nor with the taxation of the earnings derived by a pension fund (i.e., the returns to capital prior to the payment of pension). This can be problematic given the different points in time at which taxes may be levied (no. 10 OECD MC Comm. on Article 18):[2] First, when the contributions are made; second, when returns to any investment arise and third, when the pensions are paid out. Countries may exempt pension contributions and returns on investment while fully taxing pensions (usually referred to as EET, where E stands for exempted and T for taxable). Alternatively, they may tax contributions and returns to investment while exempting pension payments (TTE). They may also opt for a combination of the above by implementing a system of partial exemption or of reduced tax rates. The problems are compounded by the fact that each State usually does not follow a single model but applies a variety of approaches. In a purely domestic situation, tax legislators may and will take account of taxation at the different stages and thus generally ensure that pensions are taxed exactly once. Yet when the residence is shifted after the contributions are made but before the pensions are paid out, the overall result can be intertemporal double taxation (TTT) or tax planning opportunities[3] for intertemporal double non-taxation (EEE), both of which appear undesirable from a tax policy perspective. Moreover, much attention has been devoted to **cross-border pension schemes** and individual retirement schemes before the pay-out phase. The Comm. proposes additional rules on which the Contracting States may agree (no. 29 et seq. OECD MC Comm. on Article 18 and *infra* m.no. 84 et seq.).

1. While there are divergent definitions of what the pillars are, this corresponds more or less to the three-pillar model developed by the World Bank, *Averting the Old Age Crisis* (1994), which has shaped the pensions discourse; on this, see Dietvorst, J.B., 16 *EC Tax Review* 142 (2007).
2. On this, see Yoo, K. & De Serres, A., 39 *OECD Economic Studies*, 75 et seq. (2004).
3. Cf. Kavelaars, P., 61 *BIT*, 86 (2007); Bobeldijk, A. & Goossens, K., 39 *Intertax* 85 (2011).

http://www.pbookshop.com