1. The problem of double taxation

1.1. Basics of international law

States can levy taxes by virtue of their sovereignty. Tax sovereignty, however, is not unlimited. Not all situations can be taxed. There must either be **a personal or an objective nexus**, or connection, **between the taxpayer and the state**. With respect to a personal connecting factor, it is sufficient that this exists with respect to the person concerned. Connecting factors for individuals frequently include domicile, residence or citizenship. For legal entities, the factors usually include the place of incorporation and the place of effective management. With regard to an objective connecting factor, it is sufficient that parts of the transaction or activity involve the taxing state or that the object of the action is somehow connected to the taxing state. 1

In international law practice, there are no significant limits on the tax sovereignty of states. In designing the domestic personal tax law, the national legislator can even tax situations when, for example, only a "**genuine link**" exists. It is only when neither the person nor the transaction has any connection with the taxing state that tax cannot be levied. 2

Example 3

According to the Indian legal tax system, tax is levied when a "genuine link" exists. Pursuant to Sec. 9(1)(i) of the Income Tax Act, tax is levied on all income earned outside India which accrues, whether directly or indirectly, through or from any business connection in India. This principle formed the basis for the opinion of the Indian Authority for Advance Rulings (AAR) that a commission paid to a non-resident agent may be taxable in India even if the services are rendered outside India. Those services consisted of pursuing and soliciting the particiation of foreign concerns, undertakings and government departments in the International Food and Wine Show (IFOWS) in India. Although the activity of the agent was carried on abroad, the AAR observed that the agent's right to receive commissions arose in India when the foreign concerns, undertakings and government departments participated in the IFOWS. Therefore, the AAR considered that the agent's income accrued from a business connection in India (cf. IN, AAR 3 Jul. 2006, Rajiv Malhotra, AAR/671/2005).

1.2. Circumstances giving rise to double taxation

1.2.1. Taxation of worldwide income (full tax liability) in two states

Since international law places few limits on the tax sovereignty of states, the same event may be taxed in two or more states. Under many domestic tax law systems, a person's worldwide income is taxed if a close personal connection exists between the taxable person and that state (**universality principle**). This is called full tax liability. However, if the connection is weak or consists only of objective 4 factors, only the income earned in that state is taxed (**principle of territoriality**). This is called limited tax liability.

5 A taxable person can have close personal connections with two or more states. Under the tax laws of various states, for example, the person's domicile is a connecting factor. In others, residence and citizenship are connecting factors. Depending on the applicable laws, each of these criteria can lead to full tax liability. Therefore, it is not rare in practice, for the same person to be **subject to full tax liability in two or more states**. This can lead to the levying of taxes on worldwide income in two or more states.

6 **Example**

An individual who lives in Spain and whose centre of economic interests is in France is subject to full tax liability in both states. If there were no DTC between France and Spain, both countries would tax the person's entire worldwide income.

1.2.2. Full tax liability and limited tax liability

7 More frequently, persons are subject to full tax liability on the basis of their residence, citizenship, or any other criterion of a similar nature, in just one state and receive income from another state. In that other state, they are subject to limited tax liability. This limited tax liability applies only to the income earned in that other state. When the state of residence levies tax on worldwide income, the **income from the other state is taxed twice**. Thus, full tax liability in a state and limited tax liability in another can lead to double taxation.

8 **Example**

A person resident and domiciled in the United Kingdom and subject to full tax liability therein holds shares in a Swiss corporation. The person does not have a home or domicile in Switzerland. The person receives dividends from the Swiss shares. These dividends are taxed in the United Kingdom since the person is subject to tax there on his worldwide income. In Switzerland, limited tax liability exists. Consequently, the dividends are also taxed in Switzerland.

1.2.3. Limited tax liability in two states

9 Double taxation will usually not arise when a person is subject to limited tax liability in two states. Limited tax liability is based on the principle of territoriality. The two states will levy tax only on income arising in their respective territories. However, since the scope of the limited tax liability may not be the same in both states, double taxation may even arise **on the basis of limited tax liability**.

10 **Example**

A person lives in Italy and is subject to full tax liability therein. The person receives income from shares of a corporation that has its legal seat in Germany and its place of effective management in Belgium. The dividends received from these shares are subject to limited tax liability in Germany and in Belgium. The income would be taxed a third time in Italy on the basis of the person's full tax liability if the DTCs did not provide a remedy.

1.2.4. Economic double taxation

Thus far, the discussion has focused on double taxation arising from the taxation of the same person with respect to the same income in two or more states (juridical double taxation). However, it is also possible for the same income to be **taxed in the hands of different persons**. This situation is known as economic double taxation. 11

Example 12

The parent company of an unlimited company incorporated in the United Kingdom was a US corporation. The income of the UK unlimited company was taxable in the United Kingdom in the hands of the UK unlimited company itself. For US federal income tax purposes, the UK unlimited company was classified as a disregarded entity because it had a single shareholder, unlimited liability and had not made a "check-the-box" election. The income earned by the UK unlimited company was therefore considered to belong to the US parent corporation even if this income had not been distributed by the UK unlimited company. Thus, the income of the UK unlimited company was taxable in the United Kingdom and in the United States in the hands of the US parent corporation (cf. UK, SCITD 19 Nov. 2008, Bayfine UK Products v. Revenue and Customs Commissioners).

The problem of economic double taxation frequently arises in cases in which **affiliated or associated corporations,** with their legal seats in different states, enter into transactions with each other. Each residence state determines the taxable base for corporate income tax under its domestic corporate tax law. If the two companies enter into transactions with each other, the tax authorities of the two states could assign different values to those transactions (for a detailed description of transfer pricing issues, cf. m.no. 464 et seq.). Economic double taxation may then arise. 13

Example 14

A multinational group of companies has subsidiaries in China and Brazil. The Chinese company sells products to the Brazilian company for CNY 100,000. The Chinese tax authorities consider that the CNY 100,000 price is appropriate, whereas the Brazilian tax authorities are of the opinion that the appropriate price would be CNY 80,000. This may lead to economic double taxation.

1.3. Elimination of double taxation

1.3.1. Double taxation conventions

Cross-border economic relations would be considerably threatened if two or more states subjected the same income to taxation. Many states therefore enter into **bilateral international tax conventions** in order to eliminate double taxation. These agreements are called double taxation conventions (DTCs). They determine the extent to which each state may levy tax. 15

The number of DTCs is constantly growing. At present, **more than 3,000 DTCs** exist. For example, the Netherlands is party to over 90 DTCs, while Switzerland is party to over 80 DTCs and the United Kingdom has concluded more than 125 DTCs. 16

1.3.2. Unilateral measures

17 Notwithstanding the extensive DTC network, not all cross-border relations are covered by DTCs. However, many states enact **unilateral measures** to prevent international double taxation in cases that are not covered by DTCs. Unilateral measures to prevent international double taxation differ from country to country. Essentially, three types can be distinguished: the exemption of foreign-sourced income, the tax credit for foreign taxes paid on foreign-sourced income and the deduction from the taxable base of foreign taxes paid on foreign-sourced income. The United States, for example, unilaterally grants a tax credit for foreign taxes paid on foreign-source income.

18 The unilateral measures mentioned above are granted under approaches that also **vary from country to country**. Generally speaking, two approaches can be distinguished: in some countries (e.g. Germany), precise rules are set out in the law; in other countries (e.g. Austria), much leeway is left to the tax authorities. Unilateral relief from international double taxation is sometimes granted subject to reciprocity (e.g. Brazil).

19 In some countries, the unilateral measures' provisions only apply when a **DTC is not applicable**, either because no DTC is in place with the country where the income is derived from or because the personal (cf. m.no. 177 et seq.) or the substantive scope (cf. m.no. 220 et seq.) of the DTC is not fulfilled. In others, the unilateral measures' provisions also establish the details for the concrete **application of the methods** to relieve international double taxation provided for by DTCs. In the latter countries, therefore, the criteria set forth by the unilateral measures' provisions apply to determine the relief to be granted to a taxpayer under the applicable DTC.

2. State practice in the conclusion of DTCs

2.1. Conventions in international law

At the conclusion of a DTC, the two parties to the convention accept an **international law obligation**. They commit themselves to relinquishing, completely or partially, the imposition of taxes in specific situations. The convention is subject to the rules of public international law. 20

The contracting states are free to decide the manner in which they will give up taxing rights. For example, they may change domestic law so that only the transactions set out in the DTC regarding the imposition of taxes remain. Often, however, the conventions are **directly applicable** as domestic law. In this case, the DTC rules override the otherwise applicable domestic tax rules. 21

2.2. The importance of model conventions

Every DTC is negotiated separately. Nevertheless, many of the existing DTCs throughout the world resemble each other. This can be traced to the model tax conventions developed by international organizations. These **model tax conventions are** usually the starting point for bilateral negotiations. The parties to the convention only need to negotiate those points upon which they wish to deviate from the model tax convention. 22

The **work of the League of Nations** contributed to the development of standardized model tax conventions. In the years between World Wars I and II the League of Nations produced several model tax conventions which gained importance in the negotiations of bilateral tax conventions between states and left their mark on the later work of other international organizations. 23

The OEEC, and later the **OECD**, continued the work of the League of Nations. In 1963, 1977 and 1992, the OECD published model tax conventions in the area of taxes on income and on capital (cf. m.no. 29 et seq.). These agreements were further developed in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and 2017. In 1966 and in 1982, model tax conventions in the area of inheritance taxes were published (cf. m.no. 533 et seq.). 24

The United Nations published an independent UN Model in 1980; revised and updated versions were subsequently published in 2001, 2011 and 2017. 25

In most respects, the **UN Model** follows the OECD Model and deviations exist only with respect to certain issues. Major differences can be found in Art. 5 (permanent establishment), Art. 7 (business profits), Art. 9 (associated enterprises), Art. 10 (dividends), Art. 11 (interest), Art. 12 (royalties), Art. 13 (capital gains) and Art. 21 (other income). Since the UN Model is based on the interests of developing countries, these differences mostly try to ensure that the source country retains certain taxing rights. 26

27 **Example**

The OECD Model provides that royalties are taxed exclusively in the state of the recipient's residence, to the exclusion of the source state (Art. 12 OECD Model, cf. m.no. 298 et seq.). According to the UN Model, royalties may also be taxed in the state in which they arise. The UN Model does not establish a tax rate for the source state but leaves this question open. The rate is to be established in bilateral negotiations. The UN Model's principle regarding source taxation for royalties considers the situation of the developing countries: know-how is provided primarily by entrepreneurs of developed countries to enterprises in developing countries. Only rarely does the opposite occur. Thus, developing countries want to retain the right to tax remuneration paid in return for know-how.

2.3. The importance of the OECD Model

28 The OECD Models have had considerable influence in international tax law. They influenced other model tax conventions and many states use the OECD Model as a basis for their **DTC negotiations**.

29 In the area of taxes on income and on capital, the first OECD Model Tax Convention was published, along with a Commentary, in 1963. Over the years the Commentary has become more and more detailed. It explains the rules extensively and provides numerous examples to better understand the provisions of the OECD Model. Both documents were developed by the OECD Committee on Fiscal Affairs. The OECD Council recommended to the Member countries to make use of the Model and the Commentary: The Council thereby recommended that Member countries should continue with their efforts to enter into bilateral tax conventions, that they should adopt the OECD Model as a basis for their negotiations and that they should continue to notify the Committee on Fiscal Affairs of their reservations on articles and observations on the Commentary. Non-Member countries are invited to express their divergent views in the positions to the OECD Model (cf. m.no. 33).

30 In **1977**, a revised OECD Model was published by the OECD Committee on Fiscal Affairs. This revision took practical experience with negotiating DTCs into account. In particular, the Commentary was considerably amended and expanded. Since then, the OECD often changes the Commentary even if the relevant provision of the OECD Model was not changed. The OECD revises its positions, sometimes they even deviate from a position they took before.

31 In **1992**, the OECD Model was again revised. The speed increased: between 1994 and 2014 there were ten amendments. Some of these were only of minor relevance. Most of the changes concerned the Commentary to the OECD Model.

32 The **2017** Update of the OECD Model was again of major relevance. It primarily comprises changes to the OECD Model that were developed through the OECD/G20 BEPS (Base Erosion and Profit Shifting) Project. The OECD tried to reduce tax planning opportunities at all levels. Tax treaties should not create opportunities

for non-taxation or reduced taxation through tax evasion or avoidance. Some of the changes were very general, such as mentioning that goal already in the preamble, others were very technical. The 2017 Update also included certain other changes to the OECD Model that had been discussed for some years and were not developed as part of the work on the treaty-related BEPS measures. Again, the Commentary was amended significantly.

2.4. Bilateral peculiarities

States that use the OECD Model as a basis for negotiations usually deviate from the model on some points. This is because most states cannot agree with all the rules of the OECD Model. Many OECD Member countries have entered reservations on specific rules of the OECD Model. The contracting states furthermore try to take into consideration their **own economic interests** as well as the **peculiarities of their law and social systems**. 33

Example 34

In the OECD Model, the PE concept is used to determine the right of a contracting state to tax the profits of an enterprise of the other contracting state. Sometimes, however, it is questionable whether certain activities constitute a PE in a contracting state. Therefore, considering the special problems in applying Art. 5 OECD Model to certain activities, Denmark reserved the right to insert in a special article relating to offshore hydrocarbon exploration and exploitation and related activities: The DTC between Denmark and Slovenia (concluded in 2001), for example, constitutes that such activities are deemed to be a PE.

Numerous states also use the OECD Model as a basis for their **own model tax conventions** and incorporate their own deviations. They use these deviating models during their bilateral negotiations. 35

Example 36

The United States is concerned about the improper use of a DTC. In order to prevent abuse, the United States attaches great importance to restrictions on the entitlement to the benefits of the DTC. Given this concern as well as other issues, the United States published its own Model Tax Convention in 1996 and issued, after an update in 2006, a new version of this model in 2016. The United States uses this model in its bilateral negotiations. Thus, many DTCs concluded by the United States contain many similarities (cf. Avi-Yonah/Tittle, BFIT 2007, 224).

Model tax conventions are also published by countries that generally agree with the OECD Model standards but want to make clear the policy principles followed by their own treaty negotiators. For example, in 2007, Belgium published its own Draft Standard Model Convention and related Protocol although, at that time, it had made only seven reservations on the OECD Model and two observations on the Commentary. The **Belgian Model** (further updated in 2010) officially sets forth the policy principles that the Belgian negotiators will follow in negotiating tax treaties and is presented as such to countries that want to enter into treaty 37 negotiations with Belgium (cf. De Broe, *BFIT* 2008, 322 et seq.; the 2010 version no longer totally reflects Belgium's current tax treaty policy).

2.5. Bringing the Tax Treaties in Line with the OECD Model

38 Countries revise their bilateral tax treaties from time to time. Often, they take the opportunity to adapt their treaty to changes of the OECD Model. However, most governments have limited resources to negotiate new and renegotiate existing DTCs. It therefore often takes many years until updates of the OECD Model find their way in the bilateral DTCs. It is not rare that existing tax treaties reflect old versions of the OECD Model.

39 Since the OECD saw an urgency to implement the new and modified provisions developed under the BEPS Project in the DTCs, the "Multilateral Instrument" (MLI) was developed under the auspices of the OECD. The MLI is a multilateral convention, which swiftly modifies the application of existing bilateral tax treaties without the need to renegotiate each such treaty individually. It does not replace the existing tax treaties, but rather changes their content (cf. Lang, *SWI* 2017, 625).

40 In principle, the provisions of the MLI are optional. If a country wishes not to apply a certain provision, it can simply opt out of its application. However, the negotiating parties (a group of more than 100 jurisdictions) agreed to set a number of mandatory rules, the so-called minimum standards, which each country wishing to use the MLI has to implement. Part of these minimum standards are measures primarily to counter treaty abuse and to a lesser extent also to improve dispute resolution mechanisms while providing flexibility to accommodate specific tax treaty policies.

41 In order for a tax treaty to be modified by the MLI, it is necessary for both signatory states to a certain tax treaty to have signed the MLI and listed the relevant treaty in its MLI position under Art. 2. Only when both signatory states have notified the same treaty, their notifications match and the MLI will be able to modify the underlying bilateral tax treaty.

42 Besides the minimum standards representing the mandatory part of the MLI, all other provisions are optional. States may choose from the provisions and apply only those they wish to modify their treaties with. Through this flexible mechanism, states are able to consider their individual tax policy approaches and only choose the provisions that make sense for their treaty network. As mentioned above, if a state wishes not to apply a certain provision, it is required to formulate a reservation and thereby opt out of the relevant provision. An exception of this general mechanism can be found in Part VI of the MLI: in order to apply the part about the arbitration provisions, a state must choose to specifically opt in.

43 The MLI was finalized in November 2016 and a first signing ceremony was held in Paris on 6 June 2017. A total of 76 jurisdictions signed the MLI in this first ceremony. In the meantime, the MLI covers almost 100 jurisdictions.

3. The effects of DTCs

3.1. The allocation of taxing rights

In DTCs the two contracting states commit themselves to relinquishing or restricting their taxing rights. This should result in the elimination of double taxation. According to some DTC rules, certain income or capital can be taxed only in one of the two contracting states. Other income or capital can be taxed by both states proportionately: the right to tax for the source state, however, is usually limited to a certain percentage. Via the application of the so-called method articles, the state of residence has to avoid double taxation (**exemption method**, cf. m.no. 412 et seq and **credit method**, cf. m.no. 430 et seq.). 44

Example 45

Under Art. 12(1) OECD Model, royalties can only be taxed in the state of residence. The source state is precluded from taxing. Dividends can, however, be taxed by the source state (Art. 10(2) OECD Model). Depending on the percentage of participation and the beneficial owner, the source state may tax dividends at 5 or 15% of the gross amount. The state of residence will also tax but will credit the taxes paid in the source state.

In tax literature, it is frequently said that DTCs **allocate jurisdiction to tax**. This terminology has been criticized (cf. Vogel, *DTC* Introd., m.no. 50). States have original jurisdiction to tax and this is in accordance with international law. If this premise is accepted, it does not make any difference, in my view, whether the effects of a DTC are described as division, allocation or distribution of taxing rights, or whether one prefers, instead of the term "taxing rights", one of the following terms: tax sources, tax claims or taxable objects. 46

In DTCs the contracting states bind themselves not to raise any taxes with respect to taxing rights that are given to the other contracting state under the tax convention. The DTC rule applies even if one of the contracting states to which the right has been given does not impose taxes. In this respect, the application of the DTC can lead to **double non-taxation**. 47

Example 48

An individual resident in Munich has immovable property in Italy. The individual sells those assets long after their acquisition and realizes a gain. Under German tax law, the individual would be liable to tax in Germany. Under the DTC, however, Germany is bound to exempt this gain from tax. Italy may tax such profits under the DTC but is limited by its domestic law to taxing within the speculation period. Under Italian domestic law, therefore, the gain on the sale is exempt from tax. As a result, the gain from the sale is taxed neither in Germany nor in Italy.

3.2. The limiting effects of DTCs

In DTCs the contracting states mutually agree to limit their taxing rights. Thus, DTCs affect the legal systems of both contracting states. In both states, domestic tax law is **restricted**. 49

50 Vogel compares the way how a DTC applies to a "**stencil**" (cf. Vogel, *DTC* Introd., m.no. 58): the treaty acts like a stencil that is placed over the pattern of domestic law and covers over certain parts. In some areas, the pattern covers the domestic tax liabilities. In these cases, the imposition of taxes is restricted or eliminated. In the areas in which the pattern has holes, the domestic tax liability remains.

51 In tax literature, it has been said that DTCs **cannot generate tax liability**; however, there is no legal basis for this statement. There is no international law rule preventing tax liabilities from being increased because of a DTC. In practice, however, DTCs serve as a limitation on tax liabilities. This does not mean though that the application of a DTC could not worsen the position of the taxable person.

52 From the limiting effects of DTCs it can be understood that the exemptions granted by DTCs only affect positive income. DTCs would therefore not prevent foreign-source **losses** from offsetting the taxpayer's taxable base in the residence state. This conclusion has been drawn by the courts of several countries (e.g. Austria, Belgium, Finland, the Netherlands and Switzerland). According to the courts of other countries (e.g. Germany), however, DTCs have effects on positive and negative income. Thus, the DTC would prevent foreign-source losses from being taken into account in determining the taxpayer's taxable base in the residence state (for a comparative summary, cf. Vogel, *DTC* Art. 23, m.no. 50 et seq.).

3.3. The relationship to domestic law

3.3.1. Implementation of DTCs into domestic law

53 DTCs are treaties under international public law. It is up to the contracting states to decide how they are implemented into domestic law. Usually, this is a **constitutional issue**. According to constitutional provisions, DTCs might either have the same status as domestic provisions or they are superior to domestic provisions or their status might be below domestic provisions.

54 The contracting states oblige themselves to **implement the substance** of the provisions of a DTC. It is up to them whether they prefer to have the DTCs as such applicable or whether they introduce domestic provisions for that purpose.

3.3.2. Priority of DTC law

55 Irrespective of their status in domestic law, the content of the rules of a DTC often contradicts with domestic rules. According to most scholars, DTC rules are **special rules** in relation to domestic tax rules. However, the priority of DTC law is based on their intention to reduce or abolish domestic tax liabilities.

56 **Example**

A construction company resident in Bangladesh is hired to build an office in India and requires 4 months for the construction. Under the Bangladesh–India DTC, the income from this project cannot be taxed by India; Art. 7 of the DTC provides that income of a