

Klaus Vogel on Double Taxation Conventions, B. Explanatory Notes

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Literature: Lippert, G., *Handbuch des Internationalen Finanzrechts*, 203ff. (2nd ed. 1928); Rosendorff, R., & Henggeler, J., *Das internationale Steuerrecht des Erdballs (loose-leaf service 1936)*; Spitaler, A., *Das Doppelbesteuerungsproblem bei den direkten Steuern (1936)*; Udina, M., *Il Diritto Internazionale Tributario*, 250ff. (1949); Bühler, O., *Prinzipien des Internationalen Steuerrechts*, 32ff., 50ff. (1964); Korn, R., & Debatin, H., *Doppelbesteuerung (loose-leaf service)*; Rädler, A., & Raupach, A., *Deutsche Steuern bei Auslandsbeziehungen*, 346ff. (1966); Teichner, K., *Internationales Steuerrecht*, 14ff., 105ff. (1967); Höhn, E., & David, E., *Doppelbesteuerungsrecht (1973)*; Langer, M., *Analysis of US Income Tax Treaties*, in: Rhoades, R., *3 Income Taxation of Foreign Related Transactions (loose-leaf service 1980)*; Ryser, W., *Introduction au Droit Fiscal International de la Suisse (1980)*; Debatin, H., *Probleme der Internationalen Doppelbesteuerung*, in: *Handbuch der Finanzwissenschaft*, 269ff. (3rd ed., Vol. IV 1982); Rivier, J.-M., *Droit Fiscal Suisse, Le Droit Fiscal International (1983)*; Ebke, W., *Double Taxation*, in: 8 EPIL, 138ff. (1985); Vogel K. (ed.), *Grundfragen des Internationalen Steuerrechts (1985)*; Pires, M., *Da dupla tributação jurídica internacional sobre o rendimento (1986)*, English: *International Juridical Double Taxation of Income (1989)*; Plagnet, B., *Droit Fiscal International (1986)*; Croxatto, G., *Diritto internazionale tributario*, 32 *Rassegna Tributaria* 447ff. (1989); McDaniel, R.P., & Ault, H.G., *Introduction to United States Income Taxation*, 173ff. (3rd ed. 1989); Vogel, K., Shannon, H.A., Doernberg, R.L., & van Raad, K., *United States Income Tax Treaties (loose-leaf service 1989)*; Dahlman, R., & Fredborg, L., *Internationell Beskattning (1990)*; Fantozzi, A., & Vogel, K., *Doppia imposizione internazionale*, in: *Digesto*, 43ff. (4th ed. 1990); Gest, G. & Tixier, G., *Droit Fiscal International (2nd ed. 1990)*; Mattson, N., *Svensk Internationell Beskattningsrätt (1990)*; Miraulo, A., *Doppia imposizione internazionale (1990)*; Jacobs, O., *Internationale Unternehmensbesteuerung (2nd ed., 1991)*; Kluge, V., *Das deutsche Internationale Steuerrecht (3rd ed. 1992)*; Mössner, J., et al., *Steuerrecht international tätiger Unternehmen (1992)*; Höhn, E. (ed.), *Handbuch des Internationalen Steuerrechts der Schweiz (2nd ed. 1993)*; Schaumburg, H., *Internationales Steuerrecht (1993)*; Xavier, A., *Direito Tributário Internacional, Tributação das Operações Internacionais (1993)*; id., *Direito Tributário Internacional do Brasil (3rd ed. 1994)*; Baker, P., *Double Taxation Conventions and International Tax Law (2nd ed. 1994)*; Weizmann, L., *Dobbelbeskatningsoverenskomster vedrørende indkomst og formue (1994)*; Vogel, K., *Il diritto tributario internazionale*, in: Amatucci, A. (ed.), *Trattato di diritto tributario I/2*, 691 (1994); Malherbe, J., *Droit fiscal international (1994)*; Lindencrona, G., *Dubbelbeskatningsavtalsrätt (1994)*.

American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties, Reporters: Tillinghast, D., & Ault, H. (cited as: 'ALI Project').

OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital = OCDE Comité des Affaires Fiscales, Modèle de Convention Fiscale Concernant le Revenu et la Fortune, 1992ff. (loose-leaf; brochure 1993).

I. Double Taxation and its Avoidance

1. Circumstances giving rise to 'double taxation'

- [2] International **juridical double taxation** (for its definition see [supram.no. 01](#)), mainly arises today because the vast majority of States, in addition to levying taxes on domestic assets and domestic economic transaction, levy taxes on capital situated and transactions carried out in other countries to the extent that they benefit resident taxpayers. For example, the foreign income or foreign capital of a resident natural or juridical person is often subject to taxation based on the 'principle of residence' (taxation of **worldwide income** or **worldwide capital**). At the same time, however, no State waives its taxation of transactions or capital within its own territory even if they benefit, or belong to, non-resident persons (**principle of source**; the term 'territoriality principle' is avoided here because a variety of different meanings have been attributed to it, see Vogel, K., *Der räumliche Anwendungsbereich der Verwaltungsrechtsnorm*, 13, 14 (1965)). As a consequence, tax claims of different States necessarily overlap.

- [2a] Secondly, double taxation may also arise when a person is deemed a resident simultaneously by two (or more) States, or because source rules overlap, i.e. because two (or more) States treat the same economic transaction or item of capital as having occurred or being situated in their territory. Thirdly, double taxation may arise because certain States tax the worldwide income of their citizens even when they are residents of another State (in particular USA, Mexico, and the Philippines).
- [3] In contrast, the term '**economic double taxation**' is used to describe the situation that arises when the same economic transaction, item of income or capital is taxed in two or more States during the same period, but in the hands of different taxpayers (this has been called 'lack of subject identity': see *Bühler, O.*, [supram.no. 1](#), at 33; *Flick, H.*, 37 *StuW* 329 (1960)). Economic double taxation will occur if assets are attributed to different persons by the domestic law of the States involved, as, for example, when the tax law of one State attributes an item of capital to its legal owner whereas the tax law of the other State attributes the item of capital to the person in possession or economic control (e.g. in Germany according to § 39 *Abgabenordnung* (= Fiscal Code, hereinafter referred to as *AO*)). Economic double taxation may arise, too, if alimony paid by a husband to his wife is considered income and taxed in her hands while not being allowed to be deducted as an expense by the husband in his State of residence (*Commission cantonale de recours en matière d'impôt, Canton de Fribourg*, 42 *StRev.* 28 (1987)); or if one State taxes a legal entity at its place of residence whereas another State disregards the legal entity and taxes its income or capital by attributing it to a resident shareholder (if this situation should arise between Swiss cantons, economic double taxation, like juridical double taxation, would be prevented by Swiss domestic law: *Schweizerisches Bundesgericht* = Swiss Federal Court, hereinafter referred to as '*SchweizBG*', 51 *ASA* 497 (1983)). Further, economic double taxation can result from conflicting rules regarding the inclusion or deduction of positive and negative elements of income and capital as, for example, in cases of transfer pricing. Occasionally, the term 'economic double taxation' is also used to describe the taxation of a corporation's income which is taxed initially at the corporate level and subsequently at the shareholder level. This is the so-called 'classical system of corporate taxation'. However, this is a different situation, thus correctly *Commissione Centrale, Diritto e Pratica tributaria* II 3 (1991).
- [4] The concept of 'double taxation', its prerequisites and its limitations, have been subject to much **academic controversy**. The author's view is briefly discussed in *Fantozzi & Vogel*, [supram.no. 1](#), at I. 4; see also the 'rule of the four identities' in *Pires, M.*, [supram.no. 1](#), at 29ff. (= 9ff.), and *Xavier, A.*, [supram.no. 1](#), at 31. Application of tax treaties, however, is merely a matter of interpretation of the respective treaty. What conceptually is — and what is not — 'double taxation' is, therefore, of no importance for the treaty's application.
- [5] The law of double taxation is a branch of what is commonly called '**international tax law**'. Traditionally, this term has been used to refer to all international as well as domestic tax provisions relating specifically to situations involving the territory of more than one State, so-called 'cross-border situations' ('*grenzüberschreitende Sachverhalte*': *Bühler, O.*, [supram.no. 1](#), at 3; *Vogel, K.*, *Administrative Law*, [infram.no. 24](#), at 4; *Mössner, J.M.*, *ÖZöfR* 255 (1974)). What distinguishes international tax law from private international law is discussed separately below (see [infram.no. 24ff.](#)).

2. Double taxation and general rules of international law

- [6] **Literature:** *Garelli, A.*, *Il Diritto Internazionale Tributario* (1899); *Geyler, F.*, *Steuerliche Mehrfachbelastung und ihre normative Abwehr*, vol. 1, 169 (1931); *Isay, E.*, *Internationales Finanzrecht*, 22 (1934); *Chrétien, M.*, *A la Recherche du Droit International Fiscal Commun*, 63, 71 (1955); *Vogel, K.*, [supra m.no. 2](#), at 105ff., 114ff., 351ff.; *id.*, [supra m.no. 5](#), at 427; *Mössner, J.M.*, [supra m.no. 5](#), at 260; *Rudolf, W.*, *Über territoriale Grenzen der Steuergesetze*, in: *Festschrift J. Bärmann*, 769 (1975); *Weber-Fas, R.*, *Grundzüge des allgemeinen Steuerrechts der Bundesrepublik Deutschland*, 61 (1979); *Bayer, H.-W.*, *Das Völkerrecht in der Rechtsprechung des Bundesfinanzhofs*, 38 *StuW* 61 (1981); *Quereshi, A.H.*, *The Freedom of a State to Legislate in Fiscal Matters under General International Law*, 41 *BIFD* 14 (1987); *Martha, R.S.J.*, *The Jurisdiction to Tax in International Law* (1989).

- [7] Current international law permits taxation of foreign economic transactions when a sufficient connection exists between the taxpayer and the taxing State, as, for example, through residence, habitual abode, citizenship, situs of capital etc. See *Martha, R.S.J.*, [supram.no. 6](#), 66ff., 88ff.; *American Law Institute*, Restatement of the Law Third, The Foreign Relations Law of the United States, adopted on May 14, 1986 (1987), §§ 411f. For German case law, see *BFH BStBl. III* 253, 256 (1964); III 134, 135 (1965); 95 BFHE 345, 348 (1969). **No ‘principle of source state taxation’** (‘territoriality principle’) **of international law** prohibits application of domestic law for domestic purposes to situations arising in foreign countries, including the taxation of foreign income (this applies to ‘substantive territoriality’, see *Vogel, K.*, Anwendungsbereich, [supram.no. 6](#), at 101 (1965); as for ‘formal territoriality’ see [infram.no. 10](#)).
- [7a] A contrary view was espoused by many Latin American authors and institutions (see e.g. *Palamarchuk, A.*, Revista de la Facultad de Derecho de Montevideo 949, 987 (1959); *Valdes Costa, R.*, Estudios de Derecho Tributario Latinoamericano 283 (1982); in addition, see the ‘Declaration of Principles’ adopted by the First Latin American Tax Law Conference 1956 in Montevideo as well as several Resolutions of subsequent conferences, published by the ‘Revista’; and see the Andean Treaty, [infram.no. 20](#)). Though it deserves respect from the point of view of international comity and policy (see [infram.nos. 11ff.](#)), such a view cannot represent current international law as evidenced primarily by actual State practice. In recognition of this situation, Latin American theory has begun to retreat from its advocacy of exclusive source state taxation as a principle of international law. In some countries Latin American legislation even has adopted a system of taxation on the basis of worldwide income (*Xavier, A.*, [supram.no. 1](#), at 3; *Valdes Costa, R.*, 34 BIFD 360 (1980); *Massone, P.*, 42 BIFD 147 (1988); the same recently in Argentina), and the legislation in general today reflects a lesser adherence to the territoriality principle (*Gnazzo, E., & Piedrabuena, E.*, 34 BIFD 361 (1980)). Moreover, the criterion of ‘territoriality’ in itself is not clear and has in practice been subject to highly divergent interpretation among Latin American States (see *Engelschalk, M.*, Was bedeutet Territorialität im konkreten Fall? in: Engelschalk, M., Flick, H. & al., Steuern auf ausländische Einkünfte (7 Münchener Schriften zum Internationalen Steuerrecht) 74ff. (1985)). Similarly, in other States which follow the source state taxation principle, the question of whether income ‘arose’ domestically or ‘was derived’ within the States’ territory has required judicial clarification. For a decision involving Hong Kong, see *Privy Council CIR v. Hang Seng Bank Ltd.*, STC 733 (1990), and *CIR v. HK-TVB International Ltd.*, STC 723 (1992). It would be unfortunate, however, if the positive aspects of the earlier Latin American view, particularly from a comity and policy perspective, were to be lost in the wake of such developments (see [infram.no. 11ff.](#)).
- [7b] It is therefore admissible under international law, for example, to provide that foreign employers who hire out workers to domestic enterprises are liable for the taxes owed by their workers (*FG BW* 42 EFG 891 (1994)).
- [8] In addition, customary international law does **not forbid double taxation** (*BFH BStBl. II* 497, 498 (1975); *Vogel, K.*, [supram.no. 2](#), at 351). Double taxation, resulting from the interaction of the domestic laws of two (or more) States, will be consistent with international law as long as each individual legislation is consistent with international law. If the relevant tax provisions of all of the States involved were held to be inapplicable only when and because they give rise to double taxation, a system of loopholes could be created which would be no more acceptable than multiple taxation. Consequently, international law can decrease the incidence of double taxation only through the introduction of rules establishing which of the States involved must withdraw its tax claim. General international law does not as yet contain such rules. For the most part, only bilateral double tax treaties exist to fulfil this role (see [infram.nos. 15ff.](#)).
- [9] Current international law does not even prohibit tax laws that have **economically disadvantageous results** for another State, e.g. where tax benefits granted by another State are cancelled and made ineffective by higher taxation at home. This is not satisfactory; further development of international law would be desirable to avoid such result.
- [10] International law prohibits, however, imposition of a **sovereign act of a State on a foreign territory**. This ‘**principle of formal territoriality**’ applies in particular to acts intended to enforce internal legal provisions abroad. The principle even applies to the process of notification — whether formal or informal — of an administrative act, e.g., the assessment of tax (see *BFH BStBl. III* 181,

182 (1959) concerning delivery through simple letter; *RFH* 17 *RFHE* 159, 161 (1925) concerning delivery through registered mail; for a contrary view see *Preußisches Oberverwaltungsgericht*, *JW* 2329 (1932); generally: *Siegrist, D.*, Hoheitsakte auf fremdem Staatsgebiet (1987)). Tax audits or other such investigations in a foreign territory without the consent of the other State are considered particularly objectionable (*Weber-Fas, R.*, *supram.no. 6*, at 63; *Siebenthal, R. von*, 34 *StRev.* 382, 443, 461 (1979); *Vogel, K.*, Der räumliche Anwendungsbereich der Verwaltungsrechtsnorm 347 (1965); *Tipke/Kruse*, § 117 AO, Anm. 1). Some years ago, Swiss authorities even issued a warrant for the arrest of an official German tax fraud investigator who had performed certain investigations on Swiss territory without Swiss authorization (*Siebenthal, R. von, loc. cit.*, at 463). However, it is acceptable in principle to require the taxpayer to undertake certain **co-operative actions** (release of information, production of documents, etc.) on the occurrence of taxable cross-border events if the act is to be performed within the State requiring such 'co-operation'; regarding the extent of such co-operative duties under German law, see *Wilke, K.-M.*, *IWB F. 3 Deutschland Gr. 1*, 1335. The legitimacy of a State's demand for this type of 'co-operation' is, however, questionable under international law if the law of the foreign state prohibits the presentation of the information or documentation requested. If the sovereign acts abroad are necessary, then the national tax authorities are bound to depend upon official or legal assistance of the other country involved. Such assistance is available only according to the domestic law of the other State. A State is obligated to provide administrative or judicial assistance only if it has bound itself contractually to do so (see Art. 26 OECD MC). These rules also apply to the execution of court decisions.

3. International distribution of taxation, economic and legal aspects

[11] **Literature, Public Finance:** *von Schanz, G.*, Zur Frage der Steuerpflicht, 9 *II FinArch.* 1 (1892); *Bruins, G., & Einaudi, L., & Seligman, E., & Stamp, J.*, Report on Double Taxation submitted to the Financial Committee, League of Nations, Economic and Financial Commission (5 April 1923); *von Schanz, G.*, Die Doppelbesteuerung und der Völkerbund, 40 *FinArch.* 353 (1923); *Musgrave, R.*, Criteria for Foreign Tax Credit, in: *Taxation and Operations Abroad (Symposium)*, 83 (1960); *Richmann, P.* (now *Musgrave*), Taxation of Foreign Investment Income, An Economic Analysis (1963); *Musgrave, P.*, United States Taxation of Foreign Investment Income, Issues and Arguments (1969); *Musgrave, R. and P.*, Inter-Nation Equity, in: *Essays in Honor of Carl S. Shoup*, 63 (1972); *Ture, N.*, Taxing Foreign Source Income, in: *U.S. Taxation of American Business Abroad* 37 (1975); *Gandenberger, O.*, Kapitalexportneutralität versus Kapitalimportneutralität, in: *Aufsätze zur Wirtschaftspolitik (Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz, Heft 7)* (1983); *Sinn, H.W.*, Capital Income Taxation and Resource Allocation (1987); *Frisch, D.*, The Economics of International Tax Policy: Some Old and New Approaches, 47 *TN* 581 (1990).

Law: *Flick, H.*, Die Begrenzung der Fiskalsouveränität, *IWB F.2*, 131 (1964); *Schulze-Brachmann, A.*, Totalitäts- oder Territorialitätsprinzip, 41 *StuW* 589 (1964); *Endriss, H.-W.*, Ist die Unterscheidung zwischen unbeschränkter und beschränkter Steuerpflicht noch zeitgemäß?, 23 *FR* 338 (1968); *Tipke, K.*, Die Steuerflucht bei Internationalen Beziehungen, in: *Deutsche Landesreferate zum Öffentlichen Recht und Völkerrecht (XI. Internationaler Kongreß für Rechtsvergleichung)*, 211, 218 (1982); *Bayer, H.-W.*, Die unbeschränkte und die beschränkte Einkommensteuerpflicht — ein Vergleich, in: *Festschrift für Hermann Mosler*, 59 (1983); *Vogel, K.*, Taxation of Foreign Income, Principles and Practice, 39 *BIFD* 3, 9 (1985); *Robin, J.A.*, The Grand Illusion: A Neutral System for the Taxation of International Transactions, 75 *Virginia Law Review* 919 (1989); *Hamaekers, H.*, The Source Principle versus the Residence Principle, 3 *Revista dos Tribunais* 164 (1993); *Azzi, J.*, Policy Considerations in the Taxation of Foreign-Source Income, 47 *BIFD* 547 (1993).

Combining Finance & Law: *Vogel, K.*, The Search for Compatible Tax Systems, in: *Stein, H.* (ed.), *Tax Policy in the Twenty-First Century*, 76ff. (1988); *id.*, World-Wide vs. Source Taxation of Income, *Intertax* 216, 310, 393 (1988), reprinted in: *McLure, C. & Sinn, H.W. & Musgrave, R. and P., et. al.*, *Influence of Tax Differentials on International Competitiveness*, 115 (1990); *Owens, J.*, International Taxation and International Investment Flows between OECD and Non-OECD Countries, 45 *BIFD* 219 (1991); *Easson, A.J.*, A New International Tax Order — Responding to

the Challenge, 45 BIFD 465 (1991); *Ogley, A.*, Tax Systems and Their Interaction, 19 TPI Rev. Nov. 1992, at 3; *Hinnekens, L.*, De territorialiteit van de inkomstenbelasting op nieuwe wegen en grondslagen (1993), also in: *Joseph, G., Hinnekens, L., Malherbe, J., & van Hoorn Jr., J.* (eds.), Het Belgisch international belastingrecht in ontwikkeling, 3 (1993); *Vogel, K.*, Taxation of Cross-border Income, Harmonization and Tax Neutrality under European Community Law, An Institutional Approach (Foundation for European Fiscal Studies, Erasmus University Rotterdam, no. 2) (1994).

- [12] Regarding the question as to what criteria should be applied when dividing taxes on income and capital between two States, the answer is not only important for the basic choice incumbent upon the legislator between 'residence' and 'source' principles (see [supram.no. 2](#)). Rather, the evaluation of many legislative rules and individual measures is determined by the response to be given to this question. A concrete example is provided by the principle common throughout the world that enterprises, as a rule, are not taxed on the profits of their subsidiaries until these profits have been distributed to the enterprise. Whether this timing of taxation may be called a 'deferral' is dependent on one's theoretical framework: it is a 'deferral' only when it is presumed that comprehensive, residence-based taxation which includes the subsidiaries' profits is the better solution. Similarly, the addition of the profits of a foreign subsidiary to the resident parent's profits ('Sub-part F' of the I.R.C.; §§ 7ff. AStG) is predicated upon a policy decision in favour of the principle of world-wide taxation. Further, the assertion that a particular rule serves or does not serve the national interest presupposes that reasons have been given to establish what truly serves the national interest (without such reasons, see *Robin, J.*, [supram.no. 11](#), at 960). To the fundamental question, views have been advanced by economists and lawyers. *Richard Musgrave* very properly pointed out that when discussing such questions, a distinction should be made between economic efficiency and equity. To this, *Peggy Musgrave* added a further distinction, viz. that between aspects of individual equity with regard to the taxpayer and those of inter-nations (sometimes referred to as inter-nation) equity (see [supram.no. 11](#)). *Stanford Ross* has emphasized that a 'national' and an 'international' perspective are possible side by side (see *Ross, S.*, 4 TNI 719 (1992)).
- [13] Economists relate the term '**efficiency**' to the international allocation of factors of production, especially of capital. The allocation will be regarded as having become optimal if the use made of factors of production results in the best possible productivity — in the sense of the so-called 'pareto optimum'. The predominant view is that the best possible efficiency in allocation is obtainable by worldwide taxation in the State of residence and credit being allowed there for tax imposed by the State of source. This practice, economists say, ensures '**capital export neutrality**'. In contrast, '**capital import neutrality**' as achieved by restricting taxation to the State of source in accordance with the territoriality principle is said to be economically inefficient. Persuasive arguments have been advanced against these views, more recently so by both *Ture* and *Gandenberger* (see list of literature *supra* at [m.no. 11](#)). Your commentators would agree with the latter two authors in assuming that efficiency aspects militate in favour of exclusive taxation by the State of source, at least where business profits are concerned (see also, *Frisch, D.*, [supram.no. 11](#), at 590; *Easson, A.J.*, [supram.no. 11](#), at 468). Additional arguments based on the new '**institutional**' direction of economic research support this perspective (see *Vogel, K.*, Cross-Border Income, [supram.no. 11](#)).
- [14] Discussions of the issue of an **equitable** division of taxation usually lack depth. Mostly, a single argument is seized upon to provide the answer. Questions of equity, however, are complex and their discussion rarely produces a clear-cut result. As to international division of taxation, a distinction should be made between aspects of legitimation, equality and integrity (the latter term as defined by *Dworkin, R.*). This applies to discussions of both individual equity and equity among States. Consideration of these aspects reveals that reasons of equity militate in the same vein as reasons of efficiency do (see the foregoing m.no.), viz., that exclusive taxation by the State of source should be preferred. Most lawyers who have voiced their opinions on this matter have been in favour of the latter solution, as was also the *International Chamber of Commerce* in 1955 (see the latter's publication: Avoidance of Double Taxation, Exemption versus Tax Credit Method, Resolution of the ICC Council and Report of the Commission on Taxation, February 1955). At its 38th Congress in 1984 in Buenos Aires the *International Fiscal Association* adopted a resolution stating that 'a system of territorial taxation or of exemption of foreign income is preferable (viz. to worldwide taxation) because it is more respectful of the sovereignty of States in tax matters,

eliminates distortions of competition in the country where the investment is made, and, therefore, does not impede the free flow of investment' (for an additional explanation of that resolution, see Coulombe, G., IFA Yearbook 1984, 75ff. (1984)).

4. Avoidance of double taxation, particularly through treaties

- [15] **Literature:** See generally the literature cited *supra* [m.no. 1](#); in addition, see: Dorn, H., *Welche Grundsätze empfehlen sich für das internationale Vertragsrecht zur Vermeidung internationaler Doppelbesteuerung?* 33 *Verhandlungen des Deutschen Juristentages* 495 (1924), also in: 53 *JW* 1834 (1924); Dorn, H., *Das Recht der internationalen Doppelbesteuerung*, 1 *VjSchr.* 189 (1927); Bühler, O., *Les Accords Internationaux Concernant la Double Imposition et l'Evasion Fiscale*, 46 *RC* 433 (1936 I); Flick, H., *Methoden zur Ausschaltung der internationalen Doppelbesteuerung*, 21 *FinArch. NF* 88 (1961); Tempel, A.J. van den, *Relief from Double Taxation* (1967); Surrey, S., *Factors Affecting U.S. Treasury in Conducting International Tax Treaties*, 28 *Journal of Taxation* 277 (1968); Musgrave, P., *The OECD Model Tax Treaty: Problems and Prospects*, 10 *Columbia Journal of World's Business* 29 (1975); Bischel, J. (ed.), *Income Tax Treaties* (1978); Estes, C., *Tax Treaties*, 14 *The International Lawyer* 508 (1980); Rosenbloom, H.D., *Current Developments in Regard to Tax Treaties*, in: *New York University, Proceedings of the 40th Institute on Federal Taxation*, vol. 2, ch. 31 (1982); Gann, P., *The Concept of an Independent Treaty Foreign Tax Credit*, 38 *T.L.R.* 1 (1982); Claeys Bouúaert, I., *Verdragen tot voorkoming van de internationale dubbele belasting: hoofdtrekken en lemten*, in: *Liber amicorum Prof. Gen. F. Dumon*, vol. 2, 1003 (1983); Hund, D., *Belastingverdragen* (2nd ed. 1983); Manke, K., *Entwicklungstendenzen der Doppelbesteuerungsabkommen*, 71 *DStZ/A* 69 (1983); Prang, K.M., *Die Verhinderung der Doppelbesteuerung auf der Basis des OECD-Musterabkommens*, 29 *RIW* 355 (1983); Schreyer & Cavanagh, *Current Issues and Developments in Tax Treaties*, in: *New York University, 8th Annual Conference on International Tax and Business Planning*, 1 (1984); Ritter, W., *Entwicklungstendenzen des Internationalen Steuerrechts*, 39 *BB* 353 (1984); Davies, D.R., *Principles of International Double Taxation Relief* (1985); Shannon, H.A., *Das OECD-Musterabkommen zur Vermeidung der Doppelbesteuerung im Vergleich mit dem US-Musterabkommen*, 32 *RIW* 271 (1986); Lenz, R., & Lüthi, D., & Schüle, K., & Roth, A., & Chapuis, J.-P., & Faist, T., *Leitlinien einer schweizerischen Doppelbesteuerungspolitik*, 41 *StRev.* 503 (1986); Gröhs, B. & Herbst, C., *Die Interpretation von Doppelbesteuerungsabkommen als Problem der Auslegung von völkerrechtlichen Verträgen im nationalen Recht*. 11 *Zeitschrift für Verwaltung* 16 (Vienna, 1986); Errson, S., *Dubbelbeskatningsavtalen — en inledning*, 37 *Skattenytt* 495ff. (1987); Kuiper, W., *East-West Tax Treaties*, 41 *BIFD* 477ff. (1987); Shannon, H.A., *Die Doppelbesteuerungsabkommen der USA* (11 *Münchener Schriften zum Internationalen Steuerrecht* 1987); Gluchowski, J.G., *Tax Aspects of Joint Ventures with Western Companies Taking into Account Tax Treaties Concluded with Other Countries*, 41 *BIFD* 467 (1987); Lang, M., *Die Einwirkungen der Doppelbesteuerungsabkommen auf das innerstaatliche Recht*, *Finanz-Journal* 72 (Vienna, 1988); McDaniel, P.R., & Ault, H.G., *Introduction to United States Income Taxation*, 173 (3rd ed. 1989); Mattson, N., *Ömsesidig överenskommelse*, 57 *Svensk Skattetidning* 154 (1990); Rigby, M., *A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism*, 8 *Australian Tax Forum* 301 (1991); Ritter, W., *Die deutsche Vertragspolitik zur Vermeidung der Doppelbesteuerung*, 46 *BB* 353 (1991), in English: *The German approach to double taxation treaty negotiations*, *Intertax* 204 (1991); Zuber, B., *Anknüpfungsmerkmale und Reichweite der internationalen Besteuerung* (1991); Lang, M., *Doppelbesteuerungsabkommen und innerstaatliches Recht* (1992); Mössner, J.M., et al., *Steuerrecht international tätiger Unternehmen* 401 (1992); Ward, D.A., *Ward's Tax Treaties (Supplement to Ward's Tax Law and Practice)* (1993/94); Uckmar, V., *I trattati internazionali in materia tributaria*, in: Amatucci, A. (ed.), *Trattato di diritto tributario* I/2, 727 (1994).

The basic principles of the German conventions for the avoidance of double taxation (DTCs) with respect to the taxation of income and capital were presented in the Report of the Bundesfinanzministerium to the Finance Committee of the German Bundestag, BMF of 30.10.91, 3

EWS 74 (1992); *id.*, The choice between the exemption and credit methods in DTCs (report of 14 October 1993).

- [16] Double taxation can be avoided **unilaterally** if one of the States involved withdraws its tax claim. On behalf of the State of residence, this unilateral move often is achieved pursuant to a method developed under Anglo-American law whereby the State of residence, if it is not simultaneously the source State, allows a **credit** for the tax levied in the source State up to an amount equal to its own tax charge, as for example under US law pursuant to sec. 901 to 908 IRC, under UK law pursuant to ICTA 1988 sec. 790, under German law pursuant to § 34c *Einkommensteuergesetz* (Income Tax Law, hereinafter referred to as '*EStG*'), § 26 *Körperschaftsteuergesetz* (Corporation Tax Law, hereinafter referred to as '*KStG*'), § 11 *Vermögenssteuergesetz* (Capital Tax Law, hereinafter referred to as '*VermStG*'), and § 21 *Erbschaftsteuergesetz* (Inheritance Tax Law, hereinafter referred to as '*ErbStG*'); an overview of the corresponding rules in other jurisdictions may be found in *Hundt, F.*, 33 DB Beil. 17, 4 (1980); for a comprehensive review of how the relevant US provisions have developed, see: *McClure, W. & Bouma, H.*, 43 Tax Notes 1379ff. (1989); regarding India: *Kawatra, G.K.*, 8 TNI 169 (1994). To simplify matters, some States allow a lump sum to be deducted instead of the exact equivalent of the foreign tax paid, as Germany, for instance, does under § 34c Abs. 5 *EStG*, § 26 Abs. 6 *KStG* (see in this connection *Bundesminister der Finanzen* (Federal Minister of Finance, hereinafter referred to as '*BMF*') of 10 April 1984, BStBl. I 252 (1984) '*Pauschalierungserlaß*'; and of 31 October 1983, BStBl. I 470 (1985) '*Auslandstätigkeitenerlaß*'). In contrast, some countries avoid double taxation unilaterally through the **allowance of exemptions**: Switzerland exempts income from permanent establishments and real property located abroad (exemption with progression); the Netherlands and Australia exempt foreign source income generally, if the income is taxed in the source country (for Switzerland, see *Höhn, E.*, [supram.no. 1](#), at 62; *Ryser, W.*, [supram.no 1](#), at 35; *Constantin, Ch.*, 66b CDFI 449 (1981); for the Netherlands, see *Strik, C.*, Netherlands Reports to the Eleventh Congress of Comparative Law, 383 (1982); *Overbosch, A.*, 66b CDFI 383, 390 (1980); *Coenen, M.E.P.M., & Vranken, G.G.A.*, 57 MBB 137 (1988); for Australia, see *Mayes, P.V., & Rollo, F.A.*, 66b CDFI 191, 192 (1981)). The most extensive — and most effective — exemption of foreign income is, of course, represented by the territoriality principle as discussed *supra*, at [m.nos. 7, 12ff](#), whether it is limited to corporations as in France or Brazil (on France, see *Juilhard, P.*, 49 BIFD 107 (1995)), or also applies for personal income taxes as, e.g., in Hong Kong, Kenya and Uruguay. As a rule, however, unilateral measures are insufficient to avoid double taxation satisfactorily, because they usually are neither comprehensive nor mutually consistent.
- [17] Since the end of the nineteenth century, individual States have consequently entered into **bilateral agreements** for the avoidance of double taxation. At first only federally related or closely allied States were involved (conventions were entered between Prussia and Saxony regarding direct taxes on 16 April 1869; between Austria and Hungary regarding the taxation of business enterprises on 18 December 1869/7 January 1870; between Austria and Prussia regarding avoidance of double taxation on 21 June 1899). Following the First World War, an extensive treaty network developed in Central Europe. Germany entered its first double tax agreement with Italy in 1925. At that time, Great Britain and the United States were less active. The only comprehensive British treaty between the two World Wars was with Ireland 1922/28. The United States, following partial treaties with France in 1932 and Canada in 1936, entered its first comprehensive treaties with Sweden and France in 1939. In a hearing before the House Ways and Means Committee in 1930, US Secretary of the Treasury *Andrew W. Mellon* observed: 'The objections to this method appear to me to be that the concessions are more likely to be based on bargaining than on sound principles of taxation'. This objection was certainly wellfounded, but it could not stop a universal development of the treaties (see *Hearings before the House Ways and Means Committee on H.R. 10165, A Bill to Reduce International Double Taxation*, 71st. Cong. 2nd Sess. (1930); see, too, *Brecher, S.M.*, 24 The Tax Executive 175 (1972); *Rosenbloom, H.D.*, [supram.no. 15](#), at 31).
- [18] Efforts of the **League of Nations** contributed substantially to an assimilation of the existing bilateral treaties and to the development of uniform **model treaties**. In 1921, the Financial Committee of the League of Nations commissioned four experts on public finance, *Bruins* (Rotterdam), *Einaudi* (Turin), *Seligman* (New York) and *Stamp* (London), to prepare a report on questions regarding double taxation, which was submitted in final form in 1923. Technical experts from seven European

countries were called together in 1922 to pursue the same objective. After additional experts were added to the panel, four model treaties were drafted in 1926 and 1927, which were revised and adopted in 1928 by the representatives of 28 States (some of which were not members of the League of Nations) at a conference called by the Secretary-General of the League of Nations. To encourage further progress, the Council of the League of Nations appointed a standing committee on taxation in 1928, which in the following year drafted two competing model treaties to replace the 1928 models. A subcommittee, which due to the advent of the Second World War was composed primarily of representatives from Latin American countries, drafted the Model Treaty of **Mexico** in 1943; this was followed in 1946 by the London Model Treaty in the drafting of which industrialized States were able to participate and to bring their views to bear.

- [19] The efforts of the Organization for European Economic Co-operation (hereinafter referred to as the 'OEEC') and its successor, the Organization for Economic Co-operation and Development (hereinafter referred to as the 'OECD'), to develop a system for the avoidance of double taxation (see *supra* [m.no. 04ff.](#)) picked up where the preparatory research of the League of Nations had left off. The OEEC (OECD) Committee on Fiscal Affairs (which was formed in 1956) submitted a series of model treaty articles in four interim reports between 1956 and 1961 and a summary report in **1963** to which the complete model treaty (the '**OECD MC**') and an official commentary (hereinafter referred to as the 'Commentary' or as 'MC Comm.>') were appended. The Commentary interpreted the OECD MC; to the extent that OECD member States did not wish to follow particular recommendations in the model, they entered their **reservations** in the Commentary. The OECD MC and the Commentary were made the subject of a **recommendation of the OECD Council to the member States** pursuant to Article 5 (b) of its charter (an international agreement, cf. Art. 21). The Council recommended that member States continue their efforts to enter bilateral double tax agreements, that they adopt as the basis for their negotiations the model submitted by the Fiscal Committee 'as interpreted by the Commentaries in the Report' (French version: '*tel qu'il est interprété dans les Commentaires y relatifs*'), and that they make allowances for the limitations and reservations contained in the Commentary (Recommendation of 30 July 1963).
- [19a] In the following years, the OECD MC and Commentary were revised by the Fiscal Committee (from 1971 the Committee on Fiscal Affairs) based on practical experience, see *Messere, K.*, 47 BIFD 246 (1993). In **1977**, the Committee on Fiscal Affairs approved a **new** report with a partially revised **Model and Commentary**, which once again were sanctioned by a recommendation of the Council (dated 11 April 1977). In the following decade and a half the Fiscal Committee published a series of reports and position papers on particular issues. These reports also contained recommendations on potential treaty amendments and their formulation (see the Committee Report discussing its organization, activities, and work programme, 44 BIFD 558 (1990)). Many of these suggestions were included in the new **1992** Draft Convention, which was also approved by a recommendation of the Council (dated 23 July 1992). At the same time the Fiscal Committee stated that in the future it intends to publish **more frequent** updates to the MC and Commentary as individual issues are discussed and resolved. (This is evidenced through the publication of the MC and Commentary in loose-leaf form rather than in the bound volumes previously used, see *Messere, loc. cit.*, at 250.) The Committee realized its goal by publishing new amendments in **1994** (Recommendation of the Council from 31 March 1994), and again in **1995** (Recommendation of the Council from 20 September 1995). The changes from 1977 and those from 1992, 1994 and 1995 did not affect the model as much as the Commentary. The Commentary was made more comprehensive and the number of reservations increased. Aside from the reservations, a number of member States included '**observations**'; these observations 'do not express any disagreement with the text of the Convention, but furnish a useful indication of the way in which those countries will apply the provisions of the Article in question' (1977 Report, para 27).
- [20] An opposing model, shaped more according to the special interests of developing countries, was adopted in 1971 by the member States of the **Andean-Group** (Grupo Andino), an alliance between Bolivia, Chile, Ecuador, Colombia, Peru and — since 1973 — Venezuela. The Andean Model was drafted as an alternative to the OECD MC; it emphasizes the traditional concerns of Latin American countries, especially the source principle (the text of the Andean Model is published in Supplement D, 28 BIFD 309 (1974); see *Naranjo, E.L.*, 41 BIFD 89 (1987); *Weizman, L.*, Skat Ud. 418 (1994)). Another model treaty intended to serve the interests of developing countries was published by

the **United Nations** in 1980. This treaty is the result of more than ten years of preparation by a group of experts appointed by the United Nations Economic and Social Council (ECOSOC). Its structure corresponds to the OECD MC. Its content, however, diverges in some important respects (approved by the ECOSOC on 22 April 1980, United Nations ST/ESA/102 Resolution 1980/13 No. 1; see: *Surrey, S.*, 19 *Harvard International Law Journal* 1 (1978); *Ritter, W.*, 17 *DStZ* 419 (1979); *Hundt, F.*, 27 *RIW/AWD* 306 (1981); Presentations by *Surrey, S.*, *Widmer, M.*, *Rosenbloom, H.D.*, *Griffioen, L.*, *Dornelles, F.*, *Qureshi, N.*, & *Ritter, W.*, UN Draft Model Taxation Convention (4 IFA Congress Seminar Services (1979)); *Surrey, S.*, United Nations Model Convention for Tax Treaties between Developed and Developing Countries (5 Selected Monographs on Taxation (1980)); with regard to US treaty policy *vis-à-vis* developing countries see *Surrey, S.*, *Estes, C.*, and *Rosenbloom, H.D.*, [supra](#) [m.no. 15](#)). In the years following its adoption, UN MC gained considerable importance in negotiations between industrialized countries and developing countries, and that is why it is commented on in the following side-by-side with the OECD Model and with the US Model covered in the next paragraph.

[21] The **United States** Treasury Department published its own model treaty in 1976 to serve as the basis for US treaty negotiations. A revised model was published in 1977 and in 1981 a second revision, this time called a 'draft' (*US Department of the Treasury*, Model Income Tax Treaty of 17 May 1977, 31 *BIFD* 313 (1977), and Model Income Tax Treaty of 16 June 1981, 36 *BIFD* 15 (1982), followed by another 'draft' of Article 16 of the model on 23 December 1981). While based on the OECD MC the 'Treasury Model' is meant to reflect special US policy concerns (see *Patrick, R.*, 10 *Law and Policy in International Business* 613 (1978)). According to a letter signed by *S. Shay*, then the Treasury's International Tax Counsel, which was reprinted in 34 *Tax Notes* 60 (1987), the 1981 'drafts' have become **the US MC**; the difference in designation is immaterial. As a consequence of the 1986 US tax reform, the Treasury plans to revise its model, and a new version has long been announced, though its publication delayed [see now *infra* Annex III. 1 for the 1996 US MC, and Annex III. 2 for the Technical Explanation thereon]. For the history and analysis of the US MC, see *Vogel, K.*, *Shannon, H.*, *Doernberg, R.*, and *van Raad, K.*, United States Income Tax Treaties, since 1989 (loose-leaf). In 1988, the Netherlands Ministry of Finance published a 'standard treaty' (*standaardverdrag*, cf. *Ellis, M.*, 49 *MBB* 100 (1988)) as an annex to a document on Netherlands general treaty policy presented to the Netherlands parliament (*algemeen fiscaal verdragsbeleid*; cf. *van Brunschot, F.*, 49 *MBB* 91 (1988); *Lyons, S.*, & *van Waardenburg, D.A.*, 42 *BIFD* 374 (1988); *van Waardenburg, D.A.*, 28 *ET* 108 (1988)). Tax authorities in other countries as a rule do not have their own model treaty (in any case they have not published them), and their negotiations are usually based on the OECD or UN MCs.

[22] **Multilateral treaties** on taxation of income and capital include the OCAM (Common African, Madagascan and Mauretanian Organisation) General Agreement Regarding Fiscal Cooperation of 29 January 1971, though since terminated (for the text of the treaty, see *African Tax Systems*, Section E (loose-leaf service)), two agreements within the purview of the Council for Mutual Economic Assistance (COMECON), which has in the meantime dissolved, of 19 May 1978 (for the texts, see 19 *ET* 387 (1979); see also *Nagy, T.*, 19 *ET* 379 (1979); *G#uchowski, I.*, 32 *Osteuroparecht* 58 (1986)) and a treaty between Denmark, Norway, Sweden, Finland and Iceland (see *Bekendtgørelse Nr. 1* (Denmark) af 16. Januar 1984 af *Overenskomst af 22. Marts 1983 mellem Danmark, Finland, Island, Norge og Sverige til undgåelse af dobbeltbeskatning for sa vidt angar indkomst- og formueskatter*). The treaty was revised in 1987 and again in 1989; it now extends to include the Faroes. For an overview see 24 *ET* 30ff. (1984), and *Hallin, Y.*, 55 *Svensk Skattetidning* 93 (1988), *Tyllström, R.*, 56 *Svensk Skattetidning* 460 (1989). Regarding the importance of the Scandinavian multilateral treaty see *Mattson, N.*, Is the Multilateral Convention a Solution for the Future? — Comments with Reflections on the Nordic Experience, *Intertax* 212 (1985); see also, *id.*, 57 *Svensk Skattetidning* 154 (1990); *Weizman, L.*, [supra](#) [m.no. 1](#), at 68. The possibility of a multilateral Asian-Pacific Model Treaty is discussed by *Vann, R.*, 8 *APTIRC-Bull.* 392 (1990).

[23] As yet, no effort has been made to develop a multilateral treaty for the **European Community**. However, Article 220 of the EEC Agreement obligates member States to initiate bilateral negotiations to the extent necessary to ensure the elimination of double taxation within the Community (see *Lehner, M.*, Möglichkeiten zur Verbesserung des Verständigungsverfahrens

auf der Grundlage des EWG-Vertrages (4 Münchener Schriften zum Internationalen Steuerrecht (1982)); *Bahlmann, K.*, *Europarecht*, 43 (1985); *Scherer, T.B.*, *Doppelbesteuerung und Europäisches Gemeinschaftsrecht*, 73ff). The relationship of Community law to the DTCs of its member States is discussed [infram.no. 136ff](#).

5. Double tax treaties and private international law

- [24] **Literature:** *Neumeyer, K.*, *Internationales Finanzrecht*, 2 ZIR 186 (1914); *id.*, 4 *Internationales Verwaltungsrecht, Allgemeiner Teil*, 60, 98 (1936); *Isay, E.*, *Internationales Finanzrecht* (1934); *Bühler, O.*, *Internationales Steuerrecht und Internationales Privatrecht* (1960); *Vogel, K.*, *Der räumliche Anwendungsbereich der Verwaltungsrechtsnorm*, 194, 270, 298 (1965); *Mössner, J.M.*, *Der Begriff des Internationalen Steuerrechts in der neueren Literatur*, *ÖZöfFR* 255, 266 (1974); *Vogel, K.*, *Administrative Law, International Aspects*, in: 9 *EPIL*, 2ff. (1986); *Bar, C. von*, 1 *Internationales Privatrecht*, 216ff. (1987).
- [25] If a private transaction or event falls within the scope of the legal systems of several States, conflicts law (= 'private international law') determines which law applies. There is no uniform system of conflicts law; each State has its own rules so that differing results and imperfect legal relationships ('*hinkende Rechtsverhältnisse*') are unavoidable. The rules that determine **which law applies** are traditionally referred to as **conflict rules** ('*Kollisionsnormen*'). To the extent that tax law is based on relationships in private law, the conflicts law of the State in question determines which law applies, even when such questions arise in tax matters (e.g., whether and when a taxpayer has gained ownership of an asset).
- [26] States levy taxes, however, only on the basis of their own tax laws. Taxation based on the law of another State occurs only in extremely exceptional instances (for example, in the 1970s and '80s the USSR taxed foreign individuals and legal persons in certain cases according to the domestic laws of the State from which these persons came. See *Hacker, F.*, *Die Doppelbesteuerungsabkommen Ru#lands und der anderen GUS-Staaten*, 15 *Münchener Schriften zum Internationalen Steuerrecht* 12, 13, 28 (1992)). **Tax treaty rules** assume that both contracting States tax according to their own law; unlike the rules of private international law, therefore, treaty rules do not lead to the application of foreign law. Rather, treaty rules, to secure the avoidance of double taxation, **limit the content** of the tax law of both contracting States; in other words, the legal consequences derived from them **alter** domestic law, either by excluding application of provisions of domestic tax law where it otherwise would apply, or by obliging one or both States to allow a credit against their domestic tax for taxes paid in the other State. Within the scope of a treaty, therefore, a tax obligation exists only if and to the extent that, in addition to the requirements of domestic law, the treaty requirements also are satisfied. Consequently, rules of double taxation are not conflict rules ('*Kollisionsnormen*') similar to those in private international law. Rather, they are '**rules of limitation of law**' ('*Grenznormen*') comparable to those of an 'international administrative law' ('*Internationales Verwaltungsrecht*'), as it has been described and analysed by *Karl Neumeyer*. Ordinarily, however, such rules of limitation are embodied in, or closely related to, the substantive rules of the domestic law of the State in question (cf. *IRC* Sec. 861 to 863 — 'source rules' — 871, 881; *ICTA* 1988 sec. 584; §§ 1 Abs. 4, 49 *ESTG*). In contrast, the treaty rules have an independent origin and legal foundation.

II. Legal Framework of Double Tax Treaties

- [27] **Literature:** *Regarding international agreements in general, see: McNair, A.D.*, *The Law of Treaties* (1961); *Wengler, W.*, 1 *Völkerrecht*, 184ff. (1964); *Cavaré, L.*, 2 *Le Droit International Public Positif* 64ff. (3rd ed. 1969); *Rousseau, Ch.*, 1 *Droit International Public* 75ff. (1970); *de Visscher, Ch.*, *Théories et Réalités en Droit International Public*, 276ff. (4th ed. 1970); *O'Connell, D.P.*, 1 *International Law*, 195ff. (2nd ed. 1970); *Öhlinger, T.*, *Der völkerrechtliche Vertrag im staatlichen Recht* (1973); *Mosler, K.*, *The International Society as a Legal Community*, 140 *RC* 1 (1974 IV); *Schwarzenberger, G. & Brown, E.D.*, *A Manual of International Law*, 121ff. (6th ed. 1976); *Lauterpacht, H.*, 4 *International Law*, 95ff. (1978); *Giuliano, M.*, 1 *Diritto Internazionale*, 445ff. (2nd ed. 1983); *Verdross, A. & Simma, B.*, *Universelles Völkerrecht*, 334ff. (3rd ed. 1984);

Bastid, S., Les Traités dans la Vie Internationale — Conclusion et Effets (1985); Rosenne, S., Breach of Treaties (1985); Vierdag, E.W., Some Problems Regarding the Scope of International Instruments on the Law of Treaties, 23 AVR 409 (1985); Cronauer, H., Der internationale Vertrag im Spannungsfeld zwischen Verfassung und Völkerrecht (1986); Kühnen, R., Vorbehalte zu multilateralen Verträgen (1986); Gloria, C., Das steuerliche Verständigungsverfahren und das Recht auf diplomatischen Schutz (1988). Reuter, P., Introduction to the Law of Treaties, 1989; Brownlie, I., Principles of Public International Law (4th ed. 1990); Combacau, J., Le droits des traités, (1991); Menon, P.U., The Law of Treaties Between States and International Organizations, (1992); Quoc, N., Dailler, P., & Pellet, A., Droit International Public, 115ff. (4th ed. 1992); Seidl-Hohenveldern, I., Völkerrecht, 56ff. (8th ed. 1994);

Regarding the Vienna Convention on the Law of Treaties, see: *Rosenne, S., The Law of Treaties (1970); Maresca, A., Il Diritto dei Trattati (1971); Elias, T.O., The Modern Law of Treaties (1974); Wetzel, R.G., & Rauschnig, D., The Vienna Convention on the Law of Treaties (Travaux préparatoires) (1978); Sinclair, I., The Vienna Convention on the Law of Treaties (2nd ed. 1984); Vierdag, E.W., Some Remarks on the Relationship between the 1969 and the 1986 Vienna Convention on the Law of Treaties, 25 AVR 82 (1987); Ress, G., Verfassung und völkerrechtliches Vertragsrecht, in: Festschrift für Karl Doehring, 803ff. (1989); Rosenne, S., Developments in the Law of Treaties 1945-1986, 1989.*

Regarding tax treaty negotiations: *Milton, D., Tax Treaty Procedures, 34 BIFD 585ff. (1980); Bartlett, R.T., The Making of Double Taxation Agreements, BTR 76ff. (1991); critical: Weizman, L., Dobbeltbeskatningsaftalerne og demokratiet, Skat Ud. 290ff. (1994).*

1. Conclusion of double tax treaties and their implementation under domestic law

- [28] Double tax treaties are **international agreements**. Their creation and their consequences are determined according to the rules contained in the **Vienna Convention on the Law of Treaties** of 23 May 1969 (hereinafter referred to as 'VCLT'). As provided in Article 84 thereof, this convention came into effect on 27 January 1980 with the ratification and accession of the thirty-fifth State. With regard to States which have not entered into the Convention (the USA signed the Vienna Convention in 1970, but contrary to the United Kingdom (1980) and, more recently, Germany (1987), has not yet deposited instruments of ratification) it is important to note that the Convention to a great extent merely codifies existing norms of customary international law (*I.C.J., Namibia Case, First Advisory Opinion, ICJ Reports (1971); European Court of Human Rights, Golder Case, 18 Series A 14; House of Lords, Fothergill v. Monarch Airlines, 3 W.L.R. 209, 224 (1980); High Court of Australia, Thiel v. FCT, 21 ATR 531, 541 f. (1990)*). Supporting this view, the U.S. Department of State has on several occasions stated that it regards particular articles of the Convention as codifying existing international law. The restatement (see [supram.no. 7](#)), Part III, Introductory Note, mentions these statements; it adds, however, that '[in] a few instances the Convention moves beyond or deviates from accepted customary international Law, and the Restatement therefore departs from the Convention pending United States adherence to it'. To the extent that the Convention differs not only from the U.S.', but also from the general understanding of customary international law, international practice nevertheless increasingly adheres to the Convention's rules so that in the meantime, notwithstanding the reservations from the United States, at least with respect to the issues raised in this commentary, they have most likely achieved the status of customary international law (see *Vogel, K., & Prokisch, R., infra.no. 58*, at 32; *Verdross, A. & Simma, B., supra.no. 27*, at 346; and *Mosler, K., supra.no. 27*, at 116 where the author states as early as 1974: 'at the moment' not yet, but in the 'not so distant future').
- [29] The conclusion of a treaty is preceded by **negotiations**. In most States, including **Germany**, the Minister of Foreign Affairs is responsible for conducting treaty negotiations. Tax treaties, however, are typically negotiated by the Minister of Finance, represented by a chief negotiator. Representatives of other ministries, in Germany the Foreign Ministry in particular, participate in the negotiations to the extent necessary; in certain cases representatives of one or more of the individual German States (*Länder*) may take part.

- [30] In the **United States**, the Constitution vests the treaty-making power in the hands of the President ‘with advice and consent’ of the Senate (US Const. Art. II, Sec. 2, Cl. 2). Although it is unclear what role the framers intended the Senate to play in the actual negotiations of treaties, early practice indicates that the Senate was to advise the President to some extent during the treaty-making process, as well as to consent or withhold consent from the final treaty (see *United States Senate, Treaties and Other International Agreements: the Role of the United States Senate, Senate Committee on Foreign Relations*, 98th Cong. 2d Sess. Committee Print, (1984) at 25; hereinafter cited as ‘The Role of the Senate’). In **practice**, however, it is widely recognized that the actual negotiation of treaties is within the power of the **President** as the official channel of communication with other nations. Negotiations are carried out through individuals vested with ‘full powers’ by the President to represent the United States. Ordinarily, the State Department negotiates treaties; however, tax treaties (and protocols) are negotiated by the Office of International Tax Affairs of the Treasury Department with the assistance of Internal Revenue Service personnel. Generally, State Department participation at the negotiation level is peripheral, although the State Department must be consulted prior to the signing of a treaty (*United States Congress, Tax Treaties: Steps in the Negotiation and Ratification of Tax Treaties and Status of Proposed Treaties, Joint Committee on Taxation and Senate Committee on Foreign Relations*, 96th Cong. 1st Sess. Committee Print (1979) at 1).
- [31] During the negotiations a **treaty text** is drafted, initially only in one language. Negotiation results that are deemed less important or that only affect one side, or results that should be distinguished from the ‘main text’ of the treaty for other reasons, are often presented separately as an ‘agreed protocol’ or ‘**final protocol**’ or as an exchange of letters. Legally, however, these additional documents constitute elements of the treaty as such.
- [32] At the conclusion of the negotiations, the leaders of both delegations **authenticate** two copies of the treaty by initialling each page. If necessary, the leaders of both delegations simultaneously sign an exchange of notes or agreed protocols. If the language of negotiation was not the official language of one or both of the treaty partners, following initialling the treaty is translated into their respective languages and approved by the treaty partners. Most tax treaties are concluded in the **official languages** of both treaty partners (see recently e.g. *Germany’s DTCs with Bolivia, Costa Rica (D), Denmark (D), Mexico, Norway 1991 and Sweden 1992*). In rare instances, the treaty partners agree that a version in a third language, for example English or French, will be binding (see e.g. *Germany’s DTCs with Bangladesh, Turkey and the United Arab Emirates (D)*). If minor **modifications** to the agreed text subsequently prove necessary, the new pages containing the modifications are initialled and inserted into the text in place of the old pages. Should major modifications be required, negotiation ordinarily must be resumed.
- [33] The negotiation phase is followed by that of the conclusion of the treaty. Mere initialling does not commit the contracting States actually to conclude the treaty. A commitment to do so, albeit a limited one, does not come into being until the text of the treaty has been signed. For this purpose, the signatories — who are usually not identical with the negotiators — must be duly authorized in a manner binding under international law. In the Federal Republic of Germany, such authorization to sign the treaty must be given by the Federal President (*Bundespräsident*). By signing the treaty, the contracting States commit themselves to initiate the procedures necessary under domestic law for the binding conclusion of the treaty. But even the signing of the treaty does not constitute a binding commitment to conclude it.
- [34] In parliamentary democracies, the executive ordinarily must obtain the **consent of parliament** to conclude important agreements (the United Kingdom, see *Bartlett, R. T.*, [supram.no. 27](#), and the remaining members of the Commonwealth constitute notable exceptions). The absence of parliamentary consent, where necessary, would constitute a clear and fundamental infraction and would, pursuant to Art. 46(2) of the Vienna Convention, cause the treaty to be invalid under international law.
- [35] In the **United States** (regarding treaty making power see [supram.no. 30](#)), after the Secretary of State formally submits a treaty to the President, the President transmits the treaty to the Senate accompanied by a **Presidential message** consisting of the treaty text, a letter of transmittal requesting advice and consent of the Senate, and the earlier letter of submittal of the Secretary of State, which usually contains a detailed description and analysis of the treaty (The Role of

the Senate, [supram.no. 30](#) at 11). The **Senate procedure** is governed by Rule 30 of the Senate Rules, although the lengthy and complicated procedural requirements of this rule are usually abbreviated through the procedural mechanism of unanimous consent. (For a brief description of the constitutional background, see *Brockway, D.*, in: Canadian Tax Foundation, Reports of Proceedings of the 35th Conference, 619 (1984), see also: *Brecher, S.M.*, 24 *The Tax Executive* 175 (1972), at 178; *Rosenbloom, H.D.*, [supram.no. 15](#), at 19). The **final vote on the resolutions of ratification** requires a two-thirds majority of the Senators present for approval; the Constitution does not prescribe a quorum for treaty approval. After the Senate has given its advice and consent to a treaty, the treaty is returned through official channels to the President for **ratification**. (With regard to the various actions that may be taken by the Senate, see Restatement of the Law Third, [supram.no. 7](#), § 303 Comment and Reporter's Notes.)

- [36] In **Germany**, Art. 59 Abs. 2 *Grundgesetz* (the Federal Constitution, hereinafter referred to as 'GG') provides that 'treaties which regulate the political relations of the Federation or relate to matters of federal legislation shall require the consent or participation, in the form of a federal law, of the bodies competent in any specific case for such federal legislation'. According to Art. 105 Abs. 3 GG, these are the Federal Parliament (*Bundestag*) and in certain matters, such as legislation and treaties regarding the more important taxes, the Council of Constituent States (*Bundesrat*). The Federal Government submits a **draft of the implementing legislation** to these legislative bodies together with the treaty text, ordinarily in all languages in which the treaty was drafted, as well as any protocols and notes exchanged. As noted above, these documents constitute elements of the treaty and require parliamentary consent as well. The content and any peculiarities of the treaty are explained to the legislators by a **memorandum (Denkschrift)**. This memorandum is not an element of the treaty, but rather explains the basis for the agreed provisions. The legislative procedure is determined according to Art. 76ff. GG and §§ 78ff. *Geschäftsordnung des Deutschen Bundestages* (Rules of Procedure of the Federal Parliament). The implementing legislation is signed by the Federal President according to Art. 82 GG and promulgated in the Federal Law Gazette (*Bundesgesetzblatt*, hereinafter referred to as 'BGBl.')
- [37] **For purposes of international law**, a tax treaty comes into existence upon the **declaration of consent** by both contracting States (Art. 9 (1) VCLT). Ordinarily, the head of State is authorized to make the declaration. In Germany, the declaration under Art. 59 Abs. 1 GG is made by the Federal President. In the United States, under Article II, section 2, clause 2 of the Constitution, the President, as head of State, declares the consent of the United States to be bound by the treaty under international law. This power is ordinarily delegated to the Secretary of State or a US Ambassador.
- [38] The method by which the contracting States declare their consent is left to the contracting parties (Art. 11ff. VCLT). For important treaties, however, it is generally agreed that the conclusion of the treaty shall be effected only through an exchange of instruments, or '**ratification**' (Art. 14 (1) VCLT); for multilateral treaties, it is by deposit of instruments at a location agreed upon in the treaty through corresponding notification (Art. 14 (1), Art. 16 VCLT). Ratification is to be distinguished from parliamentary consent (see above), which frequently, primarily in the language of the media, is incorrectly termed as 'ratification'. Art. 29 of the OECD, UN and US MCs, respectively, provide for ratification of tax treaties, and treaties normally do follow the model in this respect. In the document of ratification, the authorized agent — the President in the USA, the Federal President in Germany, Austria and Switzerland — delivers the formal declaration that the constitutional requirements necessary for internal application of the treaty have been fulfilled (see [infra Art. 29, at m.nos. 7ff.](#)).
- [39] Upon declaration of intent to contract, whether through ratification or through other means, the treaty becomes binding under international law (unless the treaty provides for a different date for entry into force). The binding force of the treaty under international law is to be distinguished from its **internal applicability**. Internal applicability is a consequence only of treaties which — like tax treaties — are designed to be applied by domestic authorities in addition to obligating the States themselves, in other words, **self-executing** treaties. (GATT has been held by *Bundesfinanzhof* (the Federal Fiscal Court, hereinafter referred to as 'BFH') not to be 'self-executing'): BStBl. (*Bundessteuerblatt* = Federal Tax Gazette) III 166, 167 (1959); BStBl. III 486, 489 (1959). Direct

internal applicability of GATT has been advocated, however, by *Jackson*, 66 Michigan Law Review 250 (1967).)

- [40] In **Germany** the internal applicability of the treaty generally is achieved through enactment of implementing legislation, as provided under Art. 59 Abs. 2 GG. In the **United States**, Article VI, cl. 2 of the Constitution proclaims that, like the Constitution and federal laws, treaties constitute the supreme law of the land. Thus, in the United States, self-executing treaties automatically obtain equal status with federal laws and are internally applicable. Implementing legislation may be required, for example, where appropriations are necessary or where the terms of the treaty itself so require. With respect to tax treaties, one peculiarity arises in the United States. Article I, section 7 of the Constitution requires that all revenue raising measures arise in the House of Representatives. However, because Article II, section 2, clause 2 of the Constitution vests treaty-making power in the President subject to advice and consent of the Senate, the House of Representatives as such is not directly involved in negotiation and conclusion of tax treaties. Consequently, due to these constitutional restraints, a tax treaty may not be imposed so as to increase the United States tax burden that would exist in absence of a treaty. (See *Burke*, 23 Harvard International Law Journal 219, 221 (1983); *Brockway, D.*, [supram.no. 35](#), at 622, suggests that this constitutional background may make Congress 'somewhat less reluctant' than other States' parliaments to override treaty provisions by subsequent legislation.)
- [41] In the **United Kingdom**, where parliamentary consent is not necessary for conclusion of a treaty, the treaty becomes applicable internally only when a special law to this effect is passed by Parliament after the treaty enters into force under international law (*McNair, A.*, [supram.no. 27](#), at 81; *Oliver, J.D.B.*, BTR 388 (1970)). In special, legally authorized cases, such as for DTCs under § 788 ICTA 1988, the Queen may enact an *Order in Council* in place of parliamentary legislation (see *Baker, P.*, [supram.no. 1](#), at 46). A special law is also required in **Canada** (*Ward, D.A.*, *Treaties*, [supram.no. 15](#), at 6) and other Member States of the Commonwealth. Under **Netherlands** constitutional law, the treaty becomes applicable domestically at the time it enters into force (*van Raad, K.*, 47 MBB 49 (1978)), reflecting the 'monistic' theory of international law. In general, the conflict between 'monistic' and 'dualistic' theories has now been overcome by a compromise view (see in general: *Tunkin, G. & Wolfrum, R.* (eds.), *International Law and Municipal Law* (1988)).
- [42] The process pursuant to which a treaty acquires the force and effect of domestic law was for long referred to by German theorists as a '**transformation**', that is, as the promulgation of a domestic statute parallel to the treaty and incorporating the treaty text. A similar view can be found, though often not very explicit, in other countries, too (see, e.g., *Canadian Supreme Court*, *The Queen v. Melford Development Inc.*, D.T.C. 6281 (1982), at 6285). This theory, however, cannot explain why, among other things, the treaty, even after parliamentary consent, becomes applicable domestically only when it enters into force under international law or why it loses its binding force internally when it is rescinded or terminated at the international level. For these reasons, the German doctrine of international law abandoned the transformation theory. Parliamentary consent is now understood as a mandate through which the treaty itself — rather than a corresponding internal legislative provision — becomes applicable within the scope of domestic law. (Regarding the domestic applicability of international agreements in Germany, see *Partsch, J.*, *Die Anwendung des Völkerrechts im innerstaatlichen Recht. Überprüfung der Transformationslehre* (6 Berichte der Deutschen Gesellschaft für Völkerrecht (1964)); *Bleckmann, A.*, *Begriff und Kriterien der innerstaatlichen Anwendbarkeit völkerrechtlicher Verträge* (1970); *id.*, *Grundgesetz und Völkerrecht*, 277 (1975); *Langbein, V.*, *Intertax* 145 (1985) at 151, original German version: *Langbein, V.*, 30 RIW 531 (1984).)
- [43] The point in time at which a treaty enters into force internationally and the point at which it becomes applicable under domestic law must be distinguished from the point in time at which the **material consequences** of the treaty begin to take effect, or, in other words, the taxable period or the date from which taxation shall be limited by the treaty (the effective date). Usually this 'initiation of treaty effects' is established by explicit treaty rules (with regard to German treaties, see [infra Arts. 29/30, at m.no. 18f.](#)). Various aspects may be of importance here. Treaty rules in particular often distinguish between treaty effects on assessed taxes and those on withholding taxes. In general,

the material effects of tax treaties apply retrospectively, viewed from the date of entry into force under international law; detrimental retrospectivity may, however, be prohibited.

- [44] Through the mandate of the legislator, treaties in most States obtain the **same authority as internal law**. In some states they are even considered to have priority over domestic law. For details, see [infram.nos. 134f](#).

2. Content and elements of double taxation rules

- [45] **Literature:** Locher, P., *Zur 'negativen Wirkung' von Doppelbesteuerungsabkommen*, in: *Festgabe zum Schweizerischen Juristentag 365 (1988)*.
- [45a] Tax treaties, unlike conflict rules in private international law, do not face the problem of choosing between applicable domestic and foreign law. Instead, they recognize that each contracting State applies its own law and then they limit the contracting States' application of that law (see [supram.no. 26](#) above). Consequently, it would be **misleading** to designate treaty norms as **conflict rules** according to the usage of private international law.
- [45b] Further, treaty rules neither authorize (thus *Prebble, J.*, 11 APTIRC-Bull. 25 (1993)), nor 'allocate' jurisdiction to tax to the contracting States. Moreover, the opinion that DTCs resolve cases of conflicting jurisdiction (as *Fischer-Zernin, J.*, is still inclined to think in 33 RIW 785 (1987)) is obsolete. And even less do they attribute 'the right to tax' as some earlier DTCs appear to indicate (see *Vogel, K.*, 62 *StuW* 369 (1985); *id.*, in *Festschrift F. Klein*, 361 (1994); concurring: *Mössner, J.M.*, [infram.no. 58](#), at 414.); States have original jurisdiction to tax, as it is recognized by both constitutional laws and by public international law. Tax treaties also do not just introduce international '**source rules**' that determine in which contracting State certain income 'originates' or capital assets 'are located' (regarding this term see *McDaniel, P.R. & Ault, H.G.*, [supram.no. 15, 39ff.](#); *Vogel, K.*, in: *Anniversary Issue in Honor of Otto L. Walter*, 101ff. (1988)). Such rules must always be complemented by other rules establishing under which conditions and in relation to which contracting State the income or assets concerned may be justifiably taxed.
- [45c] Thus, DTCs establish an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or are at least theoretically possible. In other words, the contracting States mutually bind themselves not to levy taxes, or to tax only to a limited extent, in cases when the treaty reserves taxation for the other contracting State either entirely or in part. Contracting States are said to 'waive' tax claims: see *BFH BStBl. II 785, 789 (1972)*, or, more illustratively, to divide 'tax sources', the 'taxable objects' (*Steuergut*) among themselves: see *BFH BStBl. III 352, 353 (1965)* on *Germany's DTC with the Netherlands*; *BStBl. II 662 (1976)* on *Germany's DTC with Austria*; and *Becker, E.*, 18 *StuW* 763, 764 (1939).
- [45d] It could also be said that the treaty establishes 'boundaries' (*Schranken*) on domestic taxation (see *Debatin, H.*, 30 *DStR* (1992), supplement 23, 2). Finally, from the perspective of domestic tax liability, one can describe the effects of the treaty rules as providing an 'objective tax exemption' (*sachliche Steuerbefreiung*) or 'reduction' (see *BFH BStBl. II 649 (1989)*; 3 *BFH/NV* 156 (1993), *IStR* 103 (1992), with analysis by *F.W.*). None of these descriptions is theoretically wrong; they are equally valid, as long as no legal consequences are derived from the chosen description according to the usage of former 'conceptual jurisprudence'. The experts appointed in the early twenties by the League of Nations (see [supram.no. 18](#)) described this method as a classification of items of income and their assignment to the contracting States. In English, the treaty rules which perform this particular function might thus be called '**classification and assignment rules**'. This expression may not be clear enough, though, to show that both contracting States are simultaneously 'assignees' of the 'assignment'. Further, the term cannot be translated adequately into other languages. Therefore, for discussion on an international level, at least, the term '**distributive rule**' (*Verteilungsnorm*) may be suggested. The present commentary being destined for international use, the term 'distributive rule' was adopted by its authors (concurring, e.g. *Xavier, A.*, [supram.no. 1](#), at 53: '*norma de repartição*').
- [46] The limitation by a contracting State of its domestic tax law may consist of the waiver of its tax claim in favour of the other contracting State (**exemption method**) or of the grant of a credit against its tax for taxes paid in the other State (**credit method**). In contrast, a tax treaty neither generates a tax claim that does not otherwise exist under domestic law nor expands the scope

or alters the type of an existing claim, e.g. as with respect to the type of income or property (*Reichsfinanzhof* (Fiscal Court of the former German *Reich*, hereinafter referred to as '*RFH*') RStBl. 1399, 1400 (1935); 1209, 1210 (1936); 312 (1939) on Germany's DTC with *Switzerland*; *ÖstVwGH* 45 *ÖStZB* 833 (1992): *Germany's* DTC with *Austria*). The extent to which a State levies taxes within the boundaries drawn by DTCs is determined exclusively by its own domestic law (*ÖstVwGH* 45 *ÖStZB* 127 (1992)). In the Swiss literature this is described as the **(only) 'negative effect'** of DTCs (*Locher, P., supra*.no. 45, at 366, note 2; this language is also used for Brazil by *Xavier, A., supra*.no. 1, at 103). According to Swiss Constitutional law, DTCs may neither create nor increase tax liabilities, as under the Swiss Federal Constitution DTCs are not subject to a referendum (*Locher, P., supra*, at 368), the only means allowable for the imposition of taxes in Switzerland. A similar limitation exists in the USA, where, according to Art. I, Sect. 7, Cl. 1 of the US Constitution, all laws which relate to the imposition of tax liability 'shall originate' in the House of Representatives (see *Shannon, H.A., Doppelbesteuerungsabkommen, supra*.no. 15, at 100). The same also applies in the UK as a consequence of the Queen's authorization to enact a tax treaty through an 'Order in Council' only for the purpose of 'affording relief from double taxation' (*Baker, P., supra*.no. 1, at 9). And it applies, too, in Finland, where the enactment of tax legislation requires a two-thirds parliamentary majority, while only a simple majority is needed for a tax treaty to enter into force (*Viherkenttä, T., 4 TNI* 19 (1992)). Finally, according to the view of this commentary, German Constitutional law limits the power of DTCs in a similar way (as shown by *Vogel, K., in: Festschrift Peter Lerche*, 95ff. (1993)). In contrast, DTCs may grant benefits. For example, in the *United States* treaties have occasionally granted allowances for charitable contributions, deductions which were not otherwise available under domestic law (see *Rosenbloom, H.D., supra*.no. 15, at 74).

- [46a] To the extent that an exemption is agreed to, its effect is in principle independent of both whether the other contracting State imposes a tax in the situation to which the exemption applies (*RFH* RStBl. 532 (1940) regarding the *German* DTC with *Austria*; *BFH* BStBl. II 57, 59 (1973) on *Germany's* DTC with *the Netherlands*; BStBl. II 662 (1976) on *Germany's* DTC with *Austria*) and of whether that State actually levies the tax (*BFH* BStBl. II 61, 62 (1975) on *Germany's* DTC with the *United States*; see also *Hoge Road Rolno*. 20916 BNB 1983/203). Thus, it is said that the treaty prevents not only 'current' but also merely '**potential double taxation**' (for differences in Austrian tax law, see *ÖstVwGH* 47 *ÖStZB* 187 (1994)). This principle is particularly important when national tax legislation is modified after the conclusion of the treaty. Another consequence of this rule is that the contracting States are (and remain) free to grant additional exemptions or other benefits not provided for by the treaty (*Conseil d'État*, req. n. 47.293, 37 Dr. Fisc. comm. 553 (1985): DTC *France/USA*) and to eliminate, through domestic measures, double taxation not prevented by the treaty (*FG Düsseldorf*, 31 EFG 205, 207 (1983)). The exempting State ordinarily reserves the right to take the exempted elements (income or capital) into consideration in calculating the amount of the tax claim (*Progressionsvorbehalt, exemption with progression*).
- [47] Only in exceptional cases, and only when expressly agreed to by the parties, is exemption in one contracting State dependent upon whether the income or capital is taxable in the other contracting State, or upon whether it is actually taxed there. German treaties recognize four exceptions to this rule. First, two treaties deny exemption in the source State to the extent that the affected types of income or property are not taxed in the State of residence due to the application of the territoriality principle. Second, some treaties provide that where the taxpayer's State of residence taxes foreign source incomes only to the extent remitted by the taxpayer ('**remittance base principle**') the source State exemption shall be limited to the amount of source State income actually remitted. Third, some treaties stipulate that source State exemption applies only if the income in question is effectively '**subject to tax**' in the State of residence. Under this clause, treaty relief will be granted if the income is taxable in the State of residence, in principle, though not without exception, whether or not the tax is actually paid in a particular case. Finally, other special provisions are meant to prevent **treaty abuse**. For details, in particular regarding German treaty practice, see *infra* Pre Arts. 6 to 22, at m.nos. 8ff.
- [48] A theoretically **complete — paradigmatic — distributive** rule would consist of the following elements that in current treaties and treaty models usually are scattered over several articles:

I. Requirements for application

1. Binding effect of the treaty on the taxing entity (of importance, for example, for constituent States of a federation and dependent territories).
2. Treaty entitlement of the taxpayer (ordinarily determined through 'residence', Art. 1 MC).
3. Applicability of the treaty to the tax in question (the taxes specifically listed in the treaty and similar taxes, Art. 2 MC).

II. Substantive requirements

1. Designation of the particular **object** under internal tax law to which the rule will apply (the '*Objekttatbestand*': such as, 'income', 'profit', 'capital', etc.).
2. Designation of the **particular requirements** under which the distributive rule will apply (the '*Metatattbestand*'):
 - a) Designation of certain characteristics of the tax object that **give rise** to tax liability: the 'source' ('income from immovable property', 'profits of an enterprise').
 - b) Designation of certain characteristics of the tax object that determine how the **amount** of tax liability is measured (Swiss literature refers to this as 'tax separation' (*Steuerausscheidung*), i.e. exclusion from taxation of certain items of income; see *Höhn, E.*, Interkantonaies Steuerrecht, 247 ff., 371ff. (2nd ed. 1989)).
3. Connection between the *Metatattbestand* and the taxpayer: '**attribution of tax object**' ('income derived by a resident').
4. Connection between the *Metatattbestand* and the taxing State(s): '**connecting factor**' either
 - a) by a characteristic of the taxpayer (residence, citizenship), or
 - b) by characteristics of the transaction or event (e.g. the situs of immovable property).

III. The double legal consequence

1. The substantive tax law of **one** of the two contracting States remains **unaffected** within the scope of the *Metatattbestand*; the tax claim, at most, is **limited in amount** (this State has 'primary taxation').
2. The **other** contracting State allows an **exemption** for the situation (if applicable, an exemption with progression) **or** it agrees to allow a **credit** for the tax paid (this State has 'secondary taxation').

The preceding analytical overview is not a result in itself. It is helpful, however, for a better understanding of some problems connected with distributive rules, e.g. the problem of 'qualification' (see [infram.nos. 89ff.](#)).

3. Structure and application of double tax treaties

[49] The OECD and UN treaty models, as well as many of the treaties in force, are organized in **seven chapters** (see [supram.no. 1](#), at 16ff.; in contrast, the US Treaty Model is not formally organized in chapters, but follows the same pattern, except for one anti-treaty-shopping provision introduced instead of what appears as an additional distributive rule in the two other models: Art. 16). Chapters I and II regulate the requirements for application of the treaty (the '**scope of the Convention**') and determine essential definitions of treaty terms. Chapter III, the most important chapter, contains the **distributive rules** regarding **income taxes** (Articles 6 to 21), Chapter IV the distributive rules for **capital taxes** (Article 22). Chapter V provides additional legal consequences supplementing the rules of Chapters III and IV, as far as such rules do not imply a definitive legal consequence in and of themselves, and both the OECD and UN MCs here provide for a choice between the exemption method and the credit method as two equally valid solutions (Art. 23 A and 23 B). Chapter VI contains additional provisions regarding non-discrimination (Art. 24), a mutual agreement procedure for resolving uncertainties, differences of opinion and any remaining cases of double taxation (Art. 25), an exchange of information (Art. 26), a reservation for the tax privileges of diplomats and consular officials (Art. 27), and a rule for extending the treaty to dependent territories

(Art. 28). Final provisions in Chapter VII regulate the entry into force and the termination of the treaty.

- [50] The **distributive rules** of Chapter III are organized according to ‘types of income’, those of Chapter IV likewise according to ‘types of capital’. Those types of income may resemble types or schedules of income in the income tax law of various states, e.g. Germany or the United Kingdom (§ 2 *EStG*; *ICTA* 1988 sec. 17-20). Such categories may differ, however, from State to State and there are countries, such as the USA, which do not distinguish between types of income at all, but rather proceed from a comprehensive definition of income (I.R.C. Sec. 61). Types of income designated by treaties, therefore, should by no means be confused with those of domestic law, even where they do exist in domestic law; any resemblance that may show up will be superficial and accidental.
- [51] In their wording, the distributive rules of all current model treaties follow a specific pattern. If the rule provides that a particular type of income ‘*shall be taxable only in...*’, then the other State must exempt the income from its tax. If, on the other hand, the rule provides that the income ‘*maybe taxed in ...*’ (without the word ‘only’) — this formula always refers to the State of source — then the consequences in the State of residence are not determined by the rule itself, but by Article 23 of the models. In other words, distributive rules with **complete** legal consequences (‘shall ... only’) must be distinguished from rules with **incomplete** or **open** legal consequences (‘may’); distributive rules with open legal consequences are intended to be completed by application of Article 23 (see *infra* [Articles 6 to 22, at m.nos. 3ff.](#); with regard to tax treaties of the United States, attention is drawn to the ‘saving clause’, *infra* [Article 1, at m.nos. 47ff.](#)).
- [52] As mentioned before, Art. 23 of the OECD and UN MCs provides an alternative for the relief of double taxation: the contracting States in drafting that article for their particular treaty may **choose** between **exemption** and **credit methods** (the US MC provides only for the credit method). Because, however, distributive rules with complete legal consequences (‘shall ... only’) always imply exemptions, existing tax treaties almost never provide exclusively for the credit method. Similarly, the exemption method is normally not exclusive. Even where this method is adopted, Article 23A of the MCs (the exemption article) provides that, with regard to dividend and interest income, double taxation is to be avoided by credit. During the 1920s and early ‘30s, treaties in continental Europe were in fact based exclusively on the exemption method. One such treaty was *Germany’s* DTC with *Italy* 1925, which was still in force until recently.
- [53] The **distributive rules** in Chapter III are not organized in any systematic way. Rather, their arrangement has been established by tradition. With regard to their content, four general types can be distinguished.

First, rules referring to income from certain **activities** — there are four such activities: business (Article 7), independent personal services (Article 14), dependent personal services (Article 15), agriculture and forestry (in Article 6);

Second, rules referring to income from certain **assets** — four again: dividends (Article 10), interest (Article 11), royalties (Article 12) and immovable property (in Article 6);

Third, rules referring to **capital gains** — four according to the four paragraphs of Article 13;

Fourth, a rule referring to students (Article 20) and a **residuary rule** (catch-all clause) referring to income not dealt with in the foregoing three categories (Article 21).

All distributive rules not mentioned above are special rules (*leges speciales*) in relation to those listed above: e.g. Article 8 (shipping etc.) with regard to Article 7, Article 17 (artists and sportsmen) with regard to Articles 14 and 15 and, in some instances, even Article 7. Of course DTCs may also contain distributive rules which are not contained in the MC. Examples include income from profits derived from natural resources extracted from the continental shelf under Art. 20 of *Germany’s* DTC with *Norway* 1991 and the limitations on transport services in connection with offshore oil production provided under Art. 23 (4) of *Germany’s* DTC with *Denmark* (D).

- [54] If a given item of income meets the requirements of more than one distributive rule, those referring to income from assets (category 2) take **priority** over those governing income from activities (category 1) (see OECD MC, Art. 6 (4) and 7 (7); UN MC, Art. 6 (4) and 7 (6)). For example, if the business assets of an enterprise include shares of stock in a corporation, dividends derived from those shares will be treated in general under Article 10 relating to dividends, rather than

under Article 7 relating to business profits. The same applies if an enterprise has granted a loan or a patent licence to a person in the other contracting State, or if it holds immovable property in that State. There is, however, one important exception. If dividends, interest or royalties are received via a permanent establishment in the other contracting State, and if the right in respect of which such payments are made is an asset of that permanent establishment, then their taxation is determined pursuant to Article 7 ('permanent establishment proviso', see *infra* [Pre Arts. 10 to 12 m.nos. 15ff.](#)).

- [55] If, on the other hand, taxation of certain items of income is not dealt with in a DTC and if furthermore no catch-all clause (like the one provided in Art. 21 of all three models) is applicable, double taxation will persist to that extent, but it may then be eliminated by measures envisaged under domestic law (*FG Düsseldorf*, 31 EFG 205, 207 (1983)).
- [56] With regard to the procedure for **application** of a treaty, it is disputed whether treaty law or, for systematic reasons, domestic law should first be examined. *RFH* was of the opinion that tax liability according to domestic law must first be examined (RStBl. 1399, 1401 (1935) on Germany's DTC with *Switzerland*; 937 (1938) on Germany's DTC with *Italy*; 809, 810 (1940) on *Germany's* DTC with *Switzerland*; see also *Becker, E.*, 18 *StuW* 745, 762 (1939); a more restrictive view may be found in *BFH* BStBl. II 64, 65 (1979): only 'generally' as a practical rule, on *Germany's* DTC with *Switzerland*). A reversed test procedure ('*rechtssystematisch ... umgekehrter Prüfungsgang*') has been supported (see *Korn/Debatin*, Syst. III Rdn. 52; *Debatin, H.*, 13 *AWD* 477 (1969) and 30 *DStR* encl. 23, at 2 (1992); this author concedes, however, that it might be advisable for practical reasons first to examine domestic law). Only very little legal background is required to recognize that **logically**, both methods of procedure are **equivalent**. Indeed, the treaty is *lex specialis* in relation to domestic law. The requirements for application of the distributive rules are, as discussed above, **additional requirements** for establishing tax liability, aside from those of domestic law. Illustratively expressed: the treaty acts like a stencil that is placed over the pattern of domestic law and covers over certain parts. Whether the stencil or the pattern is examined first, the same conclusion results, so the order of application can be decided pragmatically from case to case (concurring: *Mössner, J.M.*, *infra* [m.no. 58](#), at 417; and *Lindencrona, G.*, 59 *Svensk Skattetidning* 125 (1992); *Wassermeyer, F.*, 67 *StuW* 404, 411 (1990) sees the questioning of this proposition as 'incomprehensible' (*unverständlich*). Only where one level refers to the other could a particular order of examination, exceptionally, be logically required (*Lindencrona, G.*, *supra*). The taxpayer, on the other hand, cannot 'choose' whether or not the treaty applies to it itself. Regarding an opposite view held by the US treasury, see *infra* [Art. 1, at m.no. 44](#).
- [57] As previously mentioned, (final) **protocols** and in some cases **other completing documents** are frequently attached to treaties. Such documents elaborate and complete the text of a treaty, sometimes even altering the text. Legally they are a part of the treaty, and their binding force is equal to that of the principal treaty text. When applying a tax treaty, therefore, it is necessary carefully to examine these additional documents.

III. Interpretation of Double Tax Treaties

- [58] **Literature:** See literature indicated *supra* at [m.nos. 1](#) and [15](#). Furthermore *Flick, H.*, *Zur Auslegung von Normen des internationalen Steuerrechts*, in: *Felix, G. (ed.), Von der Auslegung und Anwendung der Steuergesetze*, 151 (1958); *Lenz, R.*, *General Reporter, L'Interprétation des Traités de Double Imposition*, 42 *CDFI* 281ff., and *National Reports*, 165ff. (1957); *van Houtte, J.*, *Auslegungsgrundsätze im internen und im internationalen Steuerrecht* (1968); *Debatin, H.*, *Auslegungsmaximen zum internationalen Steuerrecht*, 15 *AWD* 477 (1969); *Kluge, V.*, *Die Auslegung von Doppelbesteuerungsabkommen*, 21 *RIW* 90 (1975); *Lang, J.*, *Grundsätzliches zur Interpretation völkerrechtlicher Abkommen im Steuerrecht*, 52 *StuW* 285 (1975); *Ward, D.A.*, *Principles to be applied in Interpreting Tax Treaties*, *C.T.J.* 263 (1977), reprinted in: 34 *BIFD* 545 (1980); *van Raad, C.*, *Interpretatie van belastingsverdragen*, 47 *MBB* 49 (1978); *Boidman, N.*, *Interpretation of Tax Treaties in Canada*, 34 *BIFD* 388 (1980); *Claeys Bouúaert, I.*, *Verdragen tot voorkoming van de internationale dubbele belasting: hoofdtrekken en leemten*, in: *Liber amicorum Prof. Gen. F. Dumon* (1993); *Brockway, D.*, *Interpretation of Tax Treaties and their Relationship in Statutory Law, A U.S. Perspective*, in: *Canadian Tax Foundation, Reports of Proceedings*

of the 35th Conference, 619 (1984); Osgood, R.K., *Interpreting Tax Treaties in Canada*, 17 *Cornell International Law Journal* 255 (1984); Philipp, A., *Besonderheiten bei der Auslegung von Doppelbesteuerungsabkommen*, 39 *ÖStZ* 216 (1986); Mössner, J.M., *Zur Auslegung von Doppelbesteuerungsabkommen*, in: *Liber amicorum I. Seidl-Hohenveldern*, 403ff. (1988); Strobl, J., *Zur Auslegung von Doppelbesteuerungsabkommen*, in: *Festschrift für G. Döllner*, 635 ff. (1988); Wassermeyer, F., *Die Auslegung von Doppelbesteuerungsabkommen durch den Bundesfinanzhof*, 67 *StuW* 404 (1990); Williams, D., *British judicial attitudes to double taxation agreements*, *Intertax* 298 (1990); Duval, M., *Interprétation des Conventions Fiscales*, *CTJ* 1206 (1991); Yoong, Pok Soy, *Some Aspects of Treaty Interpretation*, 9 *APTIRC-Bull.* 309 (1991); Vogel, K., & Prokisch, R., *General Reporters, Interpretation of double taxation conventions*, LXXVIIIa *CDFI* 55ff., and *National Reports* 161 ff. (1993); Edwardes-Ker, M., *International Tax Treaties Service, Introduction* 21 ff. (loose-leaf), (also published as: *Tax Treaty Interpretation* (loose-leaf)); Wassermeyer, F., *Die Auslegung völkerrechtlicher Verträge — Haltung des BFH*, in: Mössner/Blumenwitz et al., *Doppelbesteuerungsabkommen und nationales Recht*, (18 *Münchener Schriften zum Internationalen Steuerrecht* 19 ff. (1995); Pöllath, R., *Die Auslegung völkerrechtlicher Verträge aus der Sicht der Steuerpraxis* 18 *Münchener Schriften zum Internationalen Steuerrecht* 29 ff. (1995); Melis, G., *L'interpretazione delle convenzione internazionale*, *Rass. Trib.* 1966 (1995).

1. Distinctions from interpretation of domestic law

- [59] **International agreements**, like domestic law, require interpretation. The need for interpretation can arise from a difference of opinion between the contracting States; the agreement will then be interpreted by these States, or, if they have subjected themselves to its jurisdiction in general or for a particular case, by the International Court of Justice. Questions of interpretation with regard to application of a treaty can also arise, however, before domestic administrative authorities or courts.
- [60] In most countries, the courts are authorized to interpret treaties. *France* was until recently a major exception. In cases requiring interpretation of a tax treaty, the French *Conseil d'État* was legally bound to consult the Foreign Ministry, which in turn would forward the inquiry to the Ministry of Finance (Cavaré, L., *supram.no. 27*, at 156; Rousseau, C., *supram.no. 27*, at 258; *Conseil d'État, Droit International et Droit Français*, 29ff.). However, the *Conseil d'État* even then did not feel obligated to make a presentation to the Foreign Ministry if, in its opinion, the meaning of the treaty provision could be considered to be 'clear'. The Court had ever increasingly laid claim to this power; thus there was extensive case law by the *Conseil d'État* addressing such 'clear' questions of DTC law. In its decision on 29 June 1990, the Court finally abandoned this line of reasoning. It now feels entitled to interpret all aspects of a DTC and no longer considers Ministry consultation to be necessary (*Conseil d'État* req. n. 78.519, RJF Nr. 1096 (1990)). In the **USA**, and to a certain extent in other States as well, courts may refuse to interpret a treaty to the extent that a political question is involved ('Political Question Doctrine', see also the 'Act of State Doctrine'); apparently, however, no case has yet arisen in which a court has applied this doctrine to tax issues.
- [61] 'To interpret' is: to unfold a text, to bring it to be understood. Interpretation occurs in poetry as well as in theology. It, therefore, has been claimed that interpretation is such a general cognitive process that it cannot be regulated through law. That this view is incorrect follows from the existence of **different rules of interpretation** within the legal systems of various States (see in general *Lenz, R.*, 30 *Rassegna Tributaria* 155 (1987)).
- [62] In the **United Kingdom**, the judge is bound strictly by the wording of the statute, especially with regard to tax law. In principle he is not permitted to consider the intention of the legislators or the equity of the matter (*Cape Brandy Syndicate v. Commissioner of Inland Revenue*, 12 *Tax Cases* 358, 366 (1920)). A teleological interpretation and even more so a development of the law would be considered to be an usurpation of the rights of the legislators (*House of Lords, Buchanan v. Babco Ltd.*, 3 *W.L.R.* 907, 915 (1977): 'legislation, pure and simple'; see in particular *Fikentscher, W.*, 2 *Methoden des Rechts in vergleichender Darstellung*, 123, 125 (1975), and *Weisflog, E.*, 59 *StuW* 136 (1982)). To an extent, however, the above has to be viewed in the light of the 'new approach' of British Courts in the limited instance of tax avoidance schemes (see *infram.no. 113* and the cases cited therein). In a 1992 decision the *House of Lords* even approved, though only under very limited circumstances, of evaluating the legislative record and materials (Hansard) for

the interpretation of a law (*Pepper v. Hart*, STC 898 (1992)). In the **USA**, a somewhat more liberal interpretation of the tax law did not emerge until the 1930s (*White v. United States*, 305 U.S. 281, 292 (1938); *Walz, R.*, 59 *StuW* 1, 4 ff. (1982); for a general discussion of the US point of view toward treaty interpretation, see Restatement of the Law Third, *supram.no. 7*, §§ 325f.). In **Canada**, the majority opinion apparently continues to follow the British view (*Ward, D.A.*, *supram.no. 58*, at 546; *Boidman, N.*, *supram.no. 58*, at 395). Here, too, however, a new tendency has emerged recently to handle those traditional principles less rigidly (see *Stubart Industries Ltd. v. The Queen*, D.T.C. 6305 (1984); *Boidman, N.*, 56 *Taxes International* 27f. (1984); *Duval, M.*, *supram.no. 58*, at 1229). Tax treaty interpretation in particular is now expressly regulated in Canada by the Income Tax Conventions Interpretation Act of 1984 (ch. 48, 1984 CAN. GAZ. Part III 1863; see *Boidman, N.*, *Intertax* 383 (1983)). In a similar way, courts in **Israel** now tend to prefer a 'purposive' instead of the former 'strict' or 'literal' construction (cf. *Lapidoth, A.*, 42 *BIFD* 170 (1988)). According to **French** and **Belgian** practice, tax laws are to be interpreted against the fiscal authorities in case of doubt (*Schrameck*, conclusions, at *Conseil d'État*, req.n. 39.985, 37 *Dr. Fisc. comm.* 397 (1982); *Houtte, J. van*, 1 *Beginnelsen van het Belgisch Belastingrecht*, 204 (1966); in **France**, however, the issue apparently is contested). In the **USA** and also in **Germany**, such a rule has been rejected (*White v. United States*, *supra*; *Tipke/Kruse*, § 4 *AO Rz.* 95). These principles regarding the greater or lesser degree to which a judge is bound to the statutory wording determine the distribution and the balance of power between the legislative and judicial branches of the State; in this sense they are part of — unwritten — constitutional law. It is difficult, of course, to formulate these interpretive principles in precise terms. They do, however, share this characteristic with many other constitutional principles.

- [63] The interpretation of **international agreements**, even by domestic courts, **cannot** be based on the application of these various **domestic rules** of interpretation. This is clearly the case for interpretation by an international forum, which cannot be bound, of course, by the constitutional principles of the participating States. However, it must also hold true for treaty interpretation by domestic courts, if domestic application of the treaty is not to conflict with international obligations of the State in question. For the effective interpretation of international treaties, therefore, it is necessary to **reconcile** the various **national methods** of interpretation. On the other hand, the text of the treaty must be binding to a greater extent than is recognized in European (continental) practice regarding domestic law (see *Bernhardt, R.*, *Die Auslegung völkerrechtlicher Verträge*, 58 (1963); *Bayer, W.F.*, 20 *RabelsZ* 603, 633 (1955); for the French sector of Canada, see *Western Electric Co. v. MNR*, D.T.C. 5204, 5210 (1969)). On the other hand, treaties must be interpreted more liberally than are statutes in Anglo-American law, a principle which has been confirmed by Anglo-American case law (for US treatment, see *Geofroy v. Riggs*, 133 U.S. 642, 646 (1890); for UK, see *Stag Line v. Foscolo, Mango & Co. Ltd.*, A.C. 328, 350 (1932); *Buchanan v. Babco Shipping Ltd.*, 3 *W.L.R.* 907, 911, 920 (1977); see further, the case law reported by *Edwardes-Ker, M.*, *supram.no. 58*, at 41 ff.; for New Zealand, see *CIR v. United Dominions Trust Ltd.*, 2 *NZLR* 555 (1973)). The fundamental principles of interpretation for international agreements are, seen as a whole, not so different from those which would govern interpretation under domestic law (*Vogel, K.*, & *Prokisch, R.*, *supram.no. 58*, at 26)).

2. General principles for interpretation of international agreements

- [64] **Literature:** *Fitzmaurice, G.G.*, *The Law and Procedure of the International Court of Justice: Treaty Interpretation and Certain Other Treaty Points*, *B.Y.I.L.* 1 (1957); *Bernhardt, R.*, *Die Auslegung völkerrechtlicher Verträge* (1963); *Mössner, J.M.*, *Die Auslegung mehrsprachiger Staatsverträge*, *AVR* 273 (1971/72); *Hilf, M.*, *Die Auslegung mehrsprachiger Verträge* (1973); *Ress, G.*, *Wechselwirkungen zwischen Völkerrecht und Verfassung bei der Auslegung völkerrechtlicher Verträge*, 23 *BDGV* 7; *Schreuer, L.*, *Wechselwirkungen zwischen Völkerrecht und Verfassung bei der Auslegung völkerrechtlicher Verträge*, 23 *BDGV* 61; *Weber-Fas, R.*, *Staatsverträge im Internationalen Steuerrecht* (1982); *Kuner, Ch. B.*, *The Interpretation of Multilingual Treaties: Comparison of Texts versus the Presumption of Similar Meanings*, *ICLQ* 953 (1991); *McDougal, M.S.*, *Lasswell, H.D.*, & *Miller, J.C.*, *The Interpretation of International Agreements* (1994); *Blumenwitz, D.*, *Die Auslegung völkerrechtlicher Verträge*, in: *Mössner/*

Blumenwitz et al., Doppelbesteuerungsabkommen und nationales Recht, 18 Münchener Schriften zum Internationalen Steuerrecht 5 ff. (1995).

Regarding the Vienna Convention on the Law of Treaties, see [supram.no. 27](#). Furthermore, *Yasseen, M.K., L'Interprétation des Traités d'après la Convention de Vienne sur le Droit des Traités, III RC 1 (1976)*; *Köck, H., Vertragsinterpretation und Vertragsrechtskonvention (1976)*.

- [65] The extent to which **statutory text** or **statutory purpose** should control the interpretation of an international agreement was actively disputed in the older literature on international law. Difference of opinion also existed regarding the meaning of protocols of negotiations and other materials. The most widely-held view was that treaty obligations are to be interpreted restrictively, because parties to a treaty in doubtful cases should only be presumed to have waived their sovereignty to the extent that is unequivocally apparent from the text of the treaty (PCIJ B 12, 25; *Verdross, A., Verosta, S., and Zemanek, K., Völkerrecht 174 (5th ed. 1964)*; *Berber, F., 1 Lehrbuch des Völkerrechts 482 (2nd ed. 1975)*); this point is left open by the *Bundesfinanzhof*, see *BFH BStBl. II 797, 800 (1968)* on *Germany's DTC with the United States*.
- [66] In Germany, the **case law** regarding interpretation of international agreements was ample, but did not indicate a clear direction. In particular, the meaning of treaty wording and treaty purpose and their relation to each other was evaluated in different ways. The jurisprudence of the *RFH* and *BFH* concerning this issue is discussed in the previous edition of this commentary, [Introduction, at m.no. 66](#).
- [67] Among older decisions it was very unclear, as well, to what extent the unilateral statement of the particular government whose courts were interpreting a treaty would be admissible or whether such statement would even be requested. For more discussion on this issue, see [infram.no. 82f](#).
- [68] VCLT (see [supram.no. 27](#)) has rendered many of these earlier differences of opinion with regard to treaty interpretation obsolete. It is true that VCLT contains only relatively general rules and it, therefore, cannot make allowances for the peculiarities of tax treaties. It has resolved, nevertheless, some of the uncertainties in prior international practice. Therefore, the rules of the Vienna Convention are used in case law on the Interpretation of Double Taxation Treaties today as a basis even with regard to States which have not yet ratified the Vienna Convention (e.g., *High Court of Australia, Thiel v. FCT, 21 ATR 531, 541ff. (1990)*). The *International Fiscal Association* firmly supported this through a resolution at its 1993 Congress in Florence. According to the view of this Commentary, they constitute customary international law ([supram.no. 27](#)). The relevant provisions of Articles 31 through 33 of VCLT are reproduced below. (Regarding the particular articles, see *Yasseen, M.K. supram.no. 64*; and *Köck, H., supram.no. 64*; with regard to DTCs: *Edwardes-Ker, M., supram.no. 58*, at 51ff.; *Ward, D.A., Treaties, supram.no. 15*, at 26ff.; *Vogel, K., & Prokisch, R., supram.no. 58*). The US Restatement of the Law Third, [supram.no. 7](#), at § 325 adopted only Art. 31(1) and partly (3).

Section 3. Interpretation of Treaties

Article 31 General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
 - b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
 - a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

- c) any relevant rules of international law applicable in the relations between the parties.
- 4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32 Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

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

Article 33 Interpretation of treaties authenticated in two or more languages

- 1) When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.
- 2) A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
- 3) The terms of the treaty are presumed to have the same meaning in each authentic text.
- 4) Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

[69] In interpreting international agreements according to these rules the text of the **treaty** is of primary importance; i.e. the ‘ordinary meaning’ of the ‘terms’, and the wording not of the **individual** provision, but that of the entire agreement in **context**. The older view that primarily looked for the subjective intent of the parties to the treaty (see *Korn/Debatin Syst. III Rdn. 130*) is thereby rejected. However, subjective elements are not entirely excluded from consideration as they are implied within the **purpose** of the treaty. The ‘purpose’ referred to by VCLT, certainly, is not synonymous with the subjective intention of the contracting States, but refers to the goal of the treaty as reflected **objectively** by the treaty as a whole. Moreover, such purpose is subordinated to the wording of the treaty by the rule of Article 31 that the purpose shall influence interpretation merely by giving ‘light’ to the terms of the treaty. In other words, ‘purpose’ is not itself an independent means of interpretation.

[69a] In contrast, the **intention** of the parties, according to Art. 31 of VCLT and § 325 of the Restatement Third, *supram.no. 68*, is only significant to the degree to which it has been **expressed** in the text of the agreement (*van Raad, C., supram.no. 41*, at 55). The view that the ‘basic aim of treaty interpretation is to ascertain the intention of the parties’ (see *U.S. Tax Court Reports, Burghardt v. Commissioner (80 Tax Court 705 (1983))*), is thus contrary to current international law as established in both VCLT and the Restatement Third. Considering the intent of the treaty parties while interpreting an international treaty does not, however, always contradict the VCLT (see *Vogel, K., & Prokisch R., supram.no. 58*, at 40, against an erroneous view of the US National Report published in the same volume). According to Art. 31(4) VCLT, the parties may attribute a special meaning to a term. If such a meaning is clearly established, then the intent of the contracting parties must of course be observed as in this particular case it is expressed in the wording of the treaty. Excluded, therefore, is only an interpretation which, though corresponding to the intent of the parties, is in no way supported by the wording of the treaty. It is **even less** acceptable for a court to use as a basis of interpretation that which **it presumes** the parties must have intended. This is true even in cases where the interpretation of the treaty according to its wording may lead to a non-logical result (as in *Court of Claims, Great-West Life Assurance Co. v. US, 678 F.2d 180 (1982)*; regarding this decision see ALI-Project, *supram.no. 1*, at 46, with justified criticism).

[70] The ‘**ordinary meaning**’ of the terms is not necessarily that of everyday usage. To the extent that an internationally uniform legal usage or a legal usage consistent between the contracting States has developed, or to the extent that a specific technical language has developed in certain specialized areas, such as tax law, is this the ‘ordinary’ usage within the meaning of Art. 31(1) of

VCLT. This is particularly true for those terms which, under the influence of the OECD MC and its Commentary, have since developed into an ‘**international tax language**’ (this phrase is used by the *High Court of Australia* in *Thiel v. FCT 21 ATR 531, 537* (1990)). Paragraph 4 of Art. 31 clarifies, as already mentioned, that the contracting parties also can ascribe a meaning to a term that deviates from the ordinary meaning.

[70a] ‘**Object and purpose**’, as *supram.no. 69* tacitly assumed, is one integral expression (cf. *Yasseen, M.K., supram.no. 68*, at 55). It is used in international case law as such (*id.*), and there appears to be no reasonable interpretation of ‘object’ separate from ‘purpose’. According to Paragraph 2, the **context** of the agreement includes any related completing documents made in connection with the treaty. In the case of tax treaties, these include notes and letters exchanged at the time the treaty is signed. **Subsequent agreements** and **State practice** are also to be observed according to Art. 31(3) of VCLT. Whether such later agreements may be considered for the domestic use of a treaty depends, of course, on the constitutional law of the State concerned (see *infram.nos. 134f.*).

[71] In contrast, Art. 32 VCLT states that ‘**accompanying materials**’ which were created in the context of the treaty negotiations, such as elaborations on the treaty, supporting documents, position papers, etc., may only be referred to as a supplementary source if they confirm the interpretation resulting under Art. 31 or **in cases of doubt**. This rule was included to take into account multilateral conventions, which usually are drafted in difficult and protracted negotiations. States that later enter into such a treaty, especially the small and/or newly formed States, are often unaware of the voluminous materials that may accompany the treaty. Moreover, they cannot be expected to study these materials before entering the treaty. ‘**Technical Explanations**’, usually published by the US Department of the Treasury in connection with the publication of a treaty text, and the Reports of the Senate Foreign Relations Committee regarding a particular treaty, or the **memorandum** which the German Federal Government submits to the legislature with the draft of the implementing legislation for a tax treaty (see *supram.nos. 28ff.*) as well as other types of explanations which are created following the conclusion of the treaty negotiations, often during the parliamentary approval process, therefore, are neither part of the context of the treaty nor materials, and neither Art. 31 (1) and (2) nor Art. 32 grant their use in treaty interpretation (see *infram.no. 82e*). They are materials in the sense of Art. 32 only to the extent that these items reproduce the content of notes or letters exchanged between initialling and final signature. Documents which do not meet this requirement, therefore, are neither part of the context of the treaty nor materials, and neither Art. 31 (1) and (2) nor Art. 32 permits their use in treaty interpretation (see *infram.no. 82e*).

[72] With respect to **bilingual or multilingual agreements**, Art. 33 VCLT provides (as did customary international law prior to VCLT) that the original versions in **each language** are **equally binding**. Tax treaties generally are entered in the languages of both contracting States (see *supram.nos. 28ff.*), if those States do not share the same language. Occasionally the States will agree that, where differences exist between the two versions, a version in a third language — usually English or French — shall be binding. The domestic judge, therefore, when interpreting treaties cannot and may not limit himself to the version of the treaty written in his mother tongue; he must always refer to the foreign version as well (see *Hilf, M., supram.no. 64*, for numerous references). If the contracting States have agreed that in cases of doubt a version in a third language shall prevail, the judge must also take this version into consideration. In such cases, the third version must, of course, have been approved through the applicable constitutional procedure (see *supram.no. 28ff.*) and must be applicable under domestic law. Pointedly, but correctly, *Lord Scarman* described this situation in a case where the French version of a treaty was to be decisive by saying that ‘The French text is, therefore, English law’. For examples in which courts referred to the version of a treaty in a foreign language and found that the meaning of the treaty was reflected more clearly in the text in the foreign language than in their own one: *Hoge Raad* Rolno. 25 419, BNB 1990/60: *DTC Netherlands/Canada*; *FG Köln*, 32 EFG 460 (1984): *Germany's DTC with France*). A counter-example, in which the court concluded that the treaty version in their own language would be the better one is Rolno. 28 217 BNB 1992/223: the *Netherlands' DTC with Germany*.

[72a] It is inevitable in the case of such bilingual or multilingual treaties that discrepancies in meaning between the various linguistic versions will arise. According to Art. 33 (4) of VCLT, in such cases that interpretation is to be chosen which best reconciles both (or all) texts. A recognizable influence

of a State's domestic law on the wording of the treaty may be one of the factors influencing this choice (see the Swedish *Regeringsrätt*, RÅ 1987 ref. 162; for criticism, see *Sundgren, P.*, BTR 286 (1990)). In contrast, the **language of the treaty negotiations** is not a factor to be considered (*Sundgren, P.*, *supra*, at 299). If the two (or more) versions are irreconcilable — which can result, for example, from a drafting error — the interpretation is to be guided by Art. 31, 32 of VCLT, that is, by considering the object and purpose of the treaty, its context and any supplementary means of interpretation (for an example taken from the tax treaty between Germany and the UK, see *infra* Art. 3, m.no. 23). If this approach is not possible, the treaty is defective due to the contradiction, and the case is not governed by the treaty provision in question. For example, according to Article 5 (3) of *Germany's DTC with Italy* of 1925, the German version of the rules covering dividends also applied to income from other 'securities' (*Wertpapiere*) 'that are substantially equivalent to stock' (*'die in ihrem Wesen der Aktie entsprechen'*) which does not include shares of a German limited liability company (*GmbH*) (see *RFH RStBl.* 1160 (1935); *RStBl.* 1209 (1936) on *Germany's DTC with Switzerland*). The Italian version, however, referred to '*valori mobiliari*' which would include shares of a German limited liability company. Here, in view of the contradiction, '*valori mobiliari*', if they were not '*Wertpapiere*', were not covered by the article; consequently, the treaty provisions concerning business activities applied. Another example is from *Germany's DTC with Turkey*. Art. 18 (2) in the German text covers annuities from 'accident insurance' (*Unfallversicherung*) and in Turkish from 'compensation for damage'. The English text, which is supposed to settle the issue, says, 'annuities paid ... in respect of insuring personal accidents'. In the foregoing context this makes absolutely no sense. Thus, if supplementary means of interpretation (Art. 32) do not help here, this particular article must be considered to be void.

3. Particularities of double taxation treaties

a. Common interpretation

- [73] **Literature:** See *Flick, H.*, m.no. 58; *Bayer, W.F.*, *Auslegung und Ergänzung international vereinheitlichter Normen durch staatliche Gerichte*, 20 *RabelsZ* 603 (1955); *Kropholler, J.*, *Internationales Einheitsrecht*, 258 (1975); *Munday, R.J.C.*, *The Uniform Interpretation of International Conventions*, *I.C.L.Q.* 450 (1978); *Hinnekens, L.*, *De relatie en interpretatieproblematiek van onze Dubbelbelastingverdragen*, *Allgemeen Fiscaal Tijdschrift* 225 (1986); *van Raad, C.*, *Open Grenzen*, 119 *WFR* 1874 (1990); *Prokisch, R.*, *Fragen der Auslegung von Doppelbesteuerungsabkommen*, 4 *SWI* 52 (1994).
- [74] Tax treaties are meant to allocate tax claims equally between the contracting States. This goal can only be achieved if the treaty is applied consistently by the authorities and courts in both contracting States. Therefore, the mandate to interpret a tax treaty 'in the light of its object and purpose' (Art. 31 (1) VCLT) leads to the requirement that states should seek the treaty interpretation which is most likely to be accepted **in both contracting States** (the goal of '**common interpretation**'). The most important pre-condition here is that courts and administrative bodies charged with applying a double tax treaty **take into consideration and evaluate the merits** of relevant decisions made by comparable institutions in the other contracting State and, if necessary, by those of third states.
- [74a] Two courts of highest jurisdiction, the *House of Lords* and the *US Supreme Court*, have issued decisions which may serve as models concerning the interpretation of an international agreement on the standardization of private law provisions. Both cases dealt with the Warsaw Convention for the Unification of Certain Rules Relating to International Carriage by Air (12 October 1929). As the purpose of the Convention was legal standardization, here, too, a common interpretation had to be sought by the Courts; the *Supreme Court* acknowledged this obligation by stating, 'We must also consult our sister signatories'. Both decisions used as a basis for their consideration the textual (French) meaning of the relevant rule. To do this they, *inter alia*, consulted legal dictionaries and French scholarly literature. Also, both examine previous judicial rulings from domestic and foreign courts. The *Supreme Court* in particular discussed a decision of the Israeli High Court, which, however, it then did not follow. Both Courts ultimately justified their own results from the purpose of the regulations being interpreted. However, before arriving at this result they

thoroughly evaluated the foreign literature and case law (*House of Lords*, *Fothergill v. Monarch Airlines*, 3 W.L.R. 209, 218 (1980); *Supreme Court*, *Eastern Airlines, Inc. v. Floyd*, 111 S.Ct. 1489 (1991)). This goal of a cross-border, common interpretation has also been recognized when other international agreements standardizing private law were interpreted; their areas include securities law, international sales law, and the private law of the international transport of goods by road and sea (*Bayer, W.F.*, [supram.no. 63](#), at 611ff.; *Kropholler, J.*, [supram.no. 73](#), at 277, 281ff.; *Mundy, R.J.C.*, [supram.no. 73](#), at 458 f.; *Canaris, C.W.*, JZ 1987, 543; *Buchanan v. Babco Shipping Ltd.*, 2 W.L.R. 107, 112 (1977); 3 W.L.R. 907, 912 (1977)). In the scholarly literature concerning international private law, such an interpretation is even postulated for choice of law rules, albeit domestic ones (*Neuhaus, P.H.*, *Die Grundbegriffe des Internationalen Privatrechts*, 49ff. (2nd ed. 1976); *Kegel, G.*, *Internationales Privatrecht*, 112f. (7th ed. 1995): ‘*Entscheidungseinklang*’, ‘harmonized decisions’).

[74b] The same must apply to tax treaties. British case law considers, rightly, the decision of the *House of Lords* in *Fothergill v. Monarch Airlines* to be the leading case for **international tax law** as well (said the *Court of Appeals* expressly, *Commerzbank*, STC 285 (1990)). That the principle of common interpretation must be considered here has been expressed with particular clarity by the *New Zealand Court of Appeal*. It stated, ‘it is well established following New Zealand’s commitment to CER that commercial legislation applicable to Australia/New Zealand transactions should in the ordinary course be accorded the same interpretations on either side of the Tasman. For similar reasons it is obviously desirable **that the same interpretation answer should be given whether a double taxation treaty question arises for determination in New Zealand or the US and in our view appropriate consideration should be given to the considered official opinion of the other party of the treaty as to its meaning**’ (Judge *Richardson* in *CIR v. JFP Energy Inc.*, 14 TRNZ 617 (1990): DTC *New Zealand/USA*). A similar point was also made by a lower Norwegian court: ‘*Der bør være stor grad av harmoni i tolkningen i de enkelte land*’ (‘there should be a high degree of harmonization in the [treaty] interpretation of individual states’), *Stavanger Byrett*, Utv. 285 (1981): DTC *Norway/USA*.

[75] Courts in **other States** also frequently follow the principle of common interpretation, even if not stated explicitly. In interpreting the tax treaty between the *United States* and *Canada*, for example, Canadian courts have referred to decisions of authorities and courts in the United States noting that these decisions, although not binding on Canada, are nevertheless persuasive (*Number 630 v. M.N.R.*, D.T.C. 300 (1959)), or, in another case, noting that they are at least not clearly erroneous and that inconsistencies should be avoided because they could result in double taxation (*Canadian Pacific Ltd. v. The Queen*, D.T.C. 6120, 6135 (1976); see also *Utah Mines Ltd. v. The Queen*, 45 D.T.C. 5245 (1991), and *Qing Gang K. Li v. The Queen*, 48 D.T.C. 6059 (1994)). The courts of the United States have responded similarly, creating a productive dialogue (*Donroy Ltd. v. United States*, 301 F. 2d 200 (9th Cir. 1962); see also *United States v. A.L. Burbank & Co. Ltd.*, 525 F.2d 9 (2d Cir. 1975), where the Second Circuit Court of Appeals came to a conclusion diverging from the Canadian case law; furthermore, see *Roberts, S. & Warren, W.*, *US Income Taxation of Foreign Corporations and Non-resident Aliens* (loose-leaf service, as of June 16, 1971, IX/7 C)). In **Germany**, *RFH* and *BFH* have applied this principle in cases involving international model agreements (see [infram.nos. 78ff.](#)), or regulations acknowledged by authorities of another State (BStBl. II 579, 581 (1969) on *Germany’s* DTC with *USA*), they have compared provisions in one treaty with those of another treaty (RStBl. 188, 189 (1938) on *Germany’s* DTC with *Czechoslovakia*; BStBl. II 281, 283 (1972) on *Germany’s* DTC with *Italy*; in favour of such comparison see *Flick, H.*, [supram.no. 58](#), at 160), or have relied on decisions of a foreign court (the *Österreichische Verfassungs- und Verwaltungsgerichtshof*, i.e. Austria’s *Constitutional and its Administrative Court*, see BStBl. II 660 (1970) on *Germany’s* DTC with *Austria*; the *Conseil d’Etat*, 21 HFR 480 (1981) regarding the 6th EC-directive on VAT).

[75a] The precept of common interpretation is also embodied in the provisions of Art. 33 of VCTL regarding the interpretation of treaties negotiated in two or more languages, especially in paragraph 4 (cf. [supram.no. 41](#)). In 1958 *Flick, H.* had already spoken out for its consideration ([supram.no. 58](#), at 151); in agreement, among others, are *Mössner, J.M.*, [supram.no. 58](#), at 406; *Edwardes-Ker, M.*, [supram.no. 58](#), at 25; *Williams, D.*, [supram.no. 58](#), at 299; *van Raad, C.*, [supram.no. 73](#), at 1877; *Baker, P.*, [supram.no. 1](#), at 40 f.; *Prokisch, R.*, [supram.no. 73](#). Very

clearly has the *Nds. FG* ruled in the same sense (37 RIW 963 (1991)). Further, the *International Fiscal Association* at its 1993 Congress in Florence strongly stated its support on behalf of an international common interpretation (*IFA Annual* at 66 (1993)).

- [76] ‘Common interpretation’ does **not** mean that the case law of the other State must be accepted **without review**. In *Corocraft v. Pan American Airways*, it is true, *Lord Denning* did support the following of foreign decisions as if they were binding, stating ‘even if I disagreed, I would follow them in a matter which is of international concern. The courts of all the countries should interpret this convention in the same way’ (see the opinion of *Lord Denning* in *Corocraft v. Pan American Airways*, 2 W.L.R. 1273, 1283 (1968)). But in our opinion this statement, while certainly impressive, goes too far. First, the decisions of foreign courts can be very inconsistent: *Ulster-Swift Ltd. v. Taunton Meat Haulage Ltd.*, 1 W.L.R. 625, 631 (1977) lists no less than twelve different legal interpretations. Second, even a majority or uniform legal view of foreign courts cannot be considered binding (see *Wery, P.*, *De Autonomie van het Eenvormig Privaatrecht*, 24 (1971); *Kropholler, J.*, *supra* [m.no. 73](#), at 281). A good example of common interpretation may give the decision of the *House of Lords* in *Fothergill v. Monarch Airlines* (3 W.L.R. 209 (1980)). In this case, the *House of Lords* thoroughly discussed and evaluated the foreign case law and commentary (*id.*, at 217), while emphasizing that the persuasive value of a decision depended, among other things, on the reputation and rank of the foreign court (*id.*, at 225). The situation, in other words, is similar to that where a court considers the decisions of another court of equal competence within the same State. Common interpretation is also a rule of interpretation in domestic law: a judge is expected to examine other decisions and evaluate their reasoning. Rather than adhering stubbornly to a unique personal view, he must choose the interpretation that is most likely to find general acceptance by other courts of his country. The same is true with regard to courts in foreign countries. As *Lord Scarman* quite correctly observed: ‘Our courts will have to develop their jurisprudence in company with the courts of other countries from case to case’ (*id.*, at 234 (opinion of *Lord Scarman*)).
- [77] Whether a judge himself must endeavour to learn about the relevant foreign cases, whether this decision is left to his discretion or whether he is limited in a particular case to calling on the parties, are questions whose answers are dependent on each States’ procedural laws. A judge is obliged to consider decisions of foreign courts, at least those regarding the treaty in question, that are brought to his attention by the parties. If he cannot read the foreign language, he must have the decisions translated. Naturally, he will make allowance for the fact that the parties will attempt to provide him primarily with the decisions that are most favourable to their positions. In most countries, in addition, the judge must use all available means to find relevant cases of foreign courts on his own. This duty to conduct research is subject, however, to a limitation of **reasonableness**, and in view of the limited possibilities currently existing in most countries to research foreign case law the boundary of reasonableness will most often be reached rather quickly. Thus, the practical problem of access to information may be a hindrance to common interpretations. Nevertheless, exceptions do exist. The decisions of English speaking courts are available as a rule to British and American judges without great difficulty, as are those of the Austrian Administrative Court and the Swiss Federal Court to the German judge.

b. References to domestic law

- [77a] The principle of common interpretation is not applicable where tax treaties refer to the domestic law of the contracting States in such a way that each contracting State is supposed to apply its **own law**, independent from that of the other contracting State, to fulfil its treaty duties. A reference of this type back to domestic law is provided for by the MCs in Art. 3 (2) (*infra* [Art. 3, m.nos. 56ff.](#)). In other cases it may be provided for implicitly (e.g., regarding the crediting procedure, *infra* [Art. 23, m.no. 157](#)), and in some situations an interpretation other than through recourse to domestic law is not possible (*infram* [no. 100f.](#)). The MCs and the individual treaties based on the MCs accept the ‘**divergent interpretations**’ which result here from such recourse to domestic law as unavoidable.
- [77b] Correctly, therefore, *Wassermeyer, F.*, maintains that treaties must be interpreted with the understanding that they can also refer to domestic law outside of the scope of Art. 3 (2) MC (with the consequence of a divergent interpretation), 67 *StuW* 404 (1990). Contrary to *Wassermeyer, F.*, *loc. cit.*, we do not agree, however, that where a treaty does not define an expression, there is

a presumption in favour of such reference to domestic law; *Wassermeyer* gives no reasons for his view. Object and purpose of tax treaties (Art. 31 (1) VCLT) militate for their congruent application in the contracting States since differing applications may either not prevent double taxation or may lead to double non-taxation. Considerations of practicality may, if under VCLT Art. 31 (1) practicality is considered a 'purpose' of the treaty, perhaps weigh against the goal of common interpretation, but they may do so only in individual cases. If the treaty adopts an MC provision, it is clear evidence for the uniform interpretation. A reference back to domestic law also does not in any way necessarily bring greater legal certainty. *Wassermeyer's* example (*supra*, at 406) shows this clearly: whether a computer adviser with a university degree exercises a profession is, it is true, neither expressly defined in Art. 14 MC, nor in § 18 of the German *EStG*. That *BFH* has decided this question regarding § 18 makes it indeed convenient to apply, or to transfer, the maxim of this decision to Art. 14. However, convenience is hardly a consideration which should govern interpretation (for more on this issue, see the discussion in: *Mössner/Blumenwitz, et al., Doppelbesteuerungsabkommen und nationales Recht*, 18 *Münchener Schriften zum Internationalen Steuerrecht* 61ff. (1995)). In order to accept that treaty measures refer to domestic law, it must, therefore, **be justified in each individual case** according to the principles of Arts. 31 and 32 VCLT.

c. The importance of the OECD Model Treaty and its commentary

- [78] **Literature:** *Dahm, G., Die völkerrechtliche Verbindlichkeit von Empfehlungen internationaler Organisationen*, 12 *DÖV* 363ff. (1959); *Hahn, H.J., & Weber, A., Die OECD — Organisation für wirtschaftliche Zusammenarbeit und Entwicklung*, 99 (1976); *Guillaume, G., L'Organisation de Coopération et de Développement Économiques et l'Évolution Récente de ses Moyens*, *AFDI* 75ff. (1979); see also *Tixier, G., Droit Fiscal International*, Para. 424, 429-432 (1979); *Avery Jones, J.F., et al., The Interpretation of Tax Treaties with Particular Reference to Article 3 (2) of the OECD Model*, *BTR* 90, 100 (1984); *Ault, H.J., The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, *Essays Int. Tax* 61, and *Intertax* 144 (1994); *Lang, M., Die Bedeutung des Musterabkommens und des Kommentars des OECD-Steuer Ausschusses für die Anwendung von Doppelbesteuerungsabkommen*, in: *Gassner/Lang/Lechner*, 11.
- [79] The **OECD MC** and its **Commentary** are very important for the interpretation of tax treaties in that they provide a source from which the courts of different States can seek a common interpretation. As early as 1934, the German Minister of Finance, to support an interpretation of the *RFH*, referred to the models and the explanations submitted at the League of Nations Double Taxation Conference in 1928 (*RStBl.* 417, 419 (1934) on *Germany's DTC with Italy*). The *Second Circuit Court of Appeals* in *United States v. Burbank*, the *Netherlands Hoge Raad* and the *Schweizerisches Bundesgericht*, i.e. the *Swiss Federal Court*, have all relied on the OECD MC in interpreting DTCs (*United States v. A.L. Burbank & Co. Ltd.*, [supram.no. 75](#), on the *United States' DTC with Canada* of 1942; *Hoge Raad* *Rolno.* 17 812 *BNB* 1976/121 on *Germany's DTC with the Netherlands*, and *Rolno.* 27 252 *BNB* 1992/379: the *Netherlands's DTC with Ireland*; *SchweizBG* 102 I b *BGE* 264 (1976) on *Switzerland's DTC with Spain*; the *Federal Court of Appeal* of Canada (*The Queen v. Crown Forest Industries*, 48 *DTC* 6107 (1994); *Sasseville, J.*, discusses the case in 48 *BIFD* 374 (1994)); the Norwegian *Høyesterett* (*Rt.* 1401 (1992); 752 (1994); see, too, *Korn/Debatin*, *Syst. III*, *Rdn.* 131, and *Ward, D.A.*, [supram.no. 58](#), at 549). The *BFH* in two instances has even referred to the OECD MC with respect to a treaty that was concluded prior to publication of the model and which, therefore, was not based on the model (*BStBl.* III 24, 27 (1966); *BStBl.* III 463, 464 (1966) on *Germany's DTC with Switzerland* 1931/57). It has not, however, made reference to the model in interpreting the previous treaty with *Italy*, because that treaty was already entered into in 1925 (*BStBl.* II 281, 283 (1972); concurring *FG Köln*, 33 *RIW* 484 (1987)). In *Sun Life Assurance v. Pearson*, the British *High Court of Justice (Chancery Division)* through *Vinelott J.* stated: 'it is common ground that in the light of the decision of the House of Lords in *Fothergill vs. Monarch Airlines* the commentaries' — viz. of OECD — 'must be referred to as a guide to the interpretation of the treaty' (*STC* 461ff. (1984), at 513). The *Canadian Tax Court* recently reached a similar conclusion in *Hinkley v. MNR*, 45 *D.T.C.* 1336 (1991); see also *Sasseville, J., loc. cit.*

- [79a] Controversial, however, is whether this practice of considering the MC and its Commentary when interpreting tax treaties is in accordance with the **rules of VCLT**. They are not ‘instrument[s] which [were] made ... in connexion with the conclusion of the treaty’ in the sense of Art. 31(2)(b) (as *van Raad, K.*, [supram.no. 58](#), at 55 argues; in contrast, but correctly, see *Ault, H.G.*, [supram.no. 78](#), at 63). Nor are they ‘preparatory work’ within the meaning of Art. 32 (see [supram.no. 68](#)). Art. 32 refers to the papers used or produced in preparing an individual treaty, not to the OECD MC or Commentary. That is evident from its rationale of the rule as described above: in contrast to the preparatory work related to an actual agreement, the OECD MC and the Commentary are generally known and easily obtainable. No reason, therefore, would exist to refer to these sources only as secondary means of interpretation as is the case for ‘preparatory work’ within the meaning of Art. 32 (dissenting *Mössner, J.M.*, [supram.no. 58](#), at 412; *Gloria, C.*, *Verständigungsverfahren*, [supram.no. 27](#), at 84ff.).
- [80] In accordance with *Ault, H.G.*, [supram.no. 78](#), the starting point should be, rather, that where OECD member States conclude tax treaties following the text of the MC, it is presumed that those states want the treaty provision to convey the meaning intended by the MC and its Commentary. This meaning is, then, as *Prokisch, R.*, [supram.no. 73](#) has correctly explained, the ‘**ordinary meaning**’ of the terms of the DTC in the sense of Art. 31 VCLT. However, if this view is not followed, as supported by *Ault, H.G.*, *supra*, it is a ‘**special meaning**’ in the sense of Art. 31(4) VCLT and is binding as such for the treaty interpretation (similarly, *Lang, M.*, [supram.no. 78](#), who supports this as being an ‘historical interpretation’). An identical view has been presented by the *High Court of Australia* by saying that MC and MC Commentary are ‘a guide to the current usage of terms by the parties’ (*Thiel v. FCT*, 21 ATR 531, 537 (1990)); but then the deduction is contradictory that they are ‘a supplementary means of interpretation’ in the sense of Art. 32 VCLT. Sceptics may certainly ask how one knows that the contracting parties actually intended to incorporate the meaning intended by the MC and MC Commentary as opposed to some other meaning into the particular treaty. That they wanted to follow these OECD Documents may, however, be presumed — as long as no particular circumstances indicate to the contrary — because as member States of the OECD, they are legally obligated to follow the Model and Commentary in principle. Both documents were the objects of two important **recommendations** (see [supram.no. 19](#)) in which the Council recommended that the governments of the member States follow the model ‘when concluding new bilateral conventions or revising existing bilateral conventions between them, to conform to the Model Convention ... as interpreted by the Commentaries thereto ...’. Such ‘recommendation’ is a measure of the Council which is provided for in Art. 5 of the OECD Convention. According to Art. 18(c) of the Procedural Rules of the OECD, a Council recommendation obliges the member States to examine whether the recommended measures are ‘opportune’ (*Hahn, H. & Weber, A.*, [supram.no. 78](#), at 99 (1976); *Guillaume, G.*, [supram.no. 78, 75](#)). In OECD practice the legal importance of recommendations is even greater (see *Guillaume, G.*, *loc. cit.*, at 135), as evidenced by the fact that States filed ‘reservations’ or included ‘observations’ regarding their particular interpretation of a recommendation when filing their general consent to the commentary. Such affirmation would not have been necessary, if a recommendation merely obliged the States to examine whether the recommendation was appropriate. At least some form of a ‘**soft obligation**’ must, therefore, be derived from the recommendation of the Council: the OECD MC must be applied unless the member State has entered original reservations or unless material reasons, such as peculiarities of the domestic law of the contracting State, weigh against the adoption of the model, with regard to an individual treaty provision. The recommendation, in other words, generates ‘a loose legal duty, but a legal duty nonetheless’ (*Dahm, G.*, 12 DÖV 363, 364 (1959)).
- [80a] The United States, as mentioned earlier, have been reluctant to conform to the OECD MC. *Rosenbloom* explains that this is a consequence of the relatively late and detached participation of the US in the drafting of the model (see *Rosenbloom, H.D.*, [supram.no. 15](#), at 59ff.). However understandable this may be from a psychological point of view, it does not dispose of the fact that the US did have the opportunity to file ‘reservations’. It is therefore also obligated, in the foregoing sense, to follow the MC and the MC Commentary. Thus, it may be presumed for the USA as well as for the other OECD member States that to the extent that a treaty follows the MC, they intend to incorporate into such treaty the meaning which can be derived from the MC and its Commentary.

- [81] As far as the interpretation of tax treaties **between OECD countries** is concerned, the following general points can be observed:
- (1) If the text of the OECD MC has been adopted **unchanged**, it is to be assumed that the contracting States intended to conform to the Council's recommendation. It follows that when interpreting such treaties, whether or not official versions are drafted in one or more languages, the model in both its original language versions (English and French) should be considered in addition to the individual treaty text(s), as should the MC Commentary. (Obviously, the Commentary cannot be applied to the extent that OECD States have indicated a view divergent from that of the Commentary by entering a reservation or observation.)
 - (2) If (a) the text of the OECD MC is **not** adopted **literally**, but a formulation is chosen that permits an interpretation consistent with the model, or if (b) a provision was adopted literally, but a related provision that differs from the OECD MC suggests a different interpretation of the literally adopted provision, a **presumption** arises, nevertheless, that an interpretation consistent with the OECD MC should apply.
 - (3) It is only if **(a) and (b) above occur simultaneously**, in other words, if (a) a model provision is not adopted literally and (b) the context suggests an interpretation diverging from the model, that the OECD MC and Commentary may be disregarded in determining the proper interpretation of the provision.
- [82] In contrast, with regard to the interpretation of treaties with or among **non-OECD States**, the OECD MC and Commentary are **less important**. An intention by the contracting parties to adopt a provision within the meaning of the OECD MC can be presumed only where (1) the text of the provision coincides with the OECD MC and (2) its context suggests no other interpretation. The weight to be given to the Commentary in such cases cannot be stated generally, but must be determined according to the circumstances of the individual cases. With regard to recent treaties with developing countries, the **UN MC** and its official **commentary** (ST/ESA/102) must be considered, but since both models coincide for the most part, the OECD MC and Commentary can be helpful for such treaties, too.
- [82a] When interpreting treaties concluded by OECD member States, only that edition of the MC Commentary which was applicable **at the time of the treaty's completion** can be binding; *Vinelott J.* correctly observed this and referred to the 1977 OECD Commentary in *Sun Life Assurance v. Pearson*, [supram.no. 79](#), at 513. This conclusion is particularly compelling if, as previously discussed, the MC Commentary conveys the 'ordinary meaning' of the treaty under Art. 31(1) VCLT and thus is binding, or in the sense of Art. 31(4) conveys a 'special meaning' which the contracting parties attributed to a particular term (see [supram.no. 80](#)), for only the Commentary which was available at the time of the treaty's conclusion was able to determine the wording, and hence the 'ordinary meaning', of the parties (*Ault, H.G.*, [supram.no. 78](#), at 64ff.; similarly, *Lang, M.*, [supram.no. 78](#), at 30ff.). If one does not subscribe to that view, it is unclear from the outset how the obligation to consider the MC Commentary in interpreting treaties could ever be derived from VCLT. It is hardly convincing to consider ensuing changes to the Commentary as a subsequent agreement **of the treaty parties** in the sense of Art. 31(3)(a) VCLT (such changes are discussed by *Ward, D.A.*, *Treaties*, [supram.no. 15](#), at 31, whose conclusion, however, seems to be the same as the one advocated here, *loc. cit.* at 41; agreeing, *Lang, M.*, [supram.no. 78](#), at 25). The 1977 MC Commentary is therefore in principle only significant for treaties which were completed after 11 April 1977, while the 1992 MC Commentary should apply only to those treaties concluded following 23 July 1992. The same pattern applies for future Commentaries, of course.
- [82b] Many changes and supplements of the MC and MC Commentary in revisions since 1977 are **only to clarify**, however, that which, in the opinion of the OECD Committee of Fiscal Affairs, already applied under the earlier MC edition. The Report accompanying the 1977 MC thus expressed in paragraph 30 the Committee's expectation that the States should consider those clarifications when applying their existing treaties 'if necessary according to a prearranged explicit understanding'. In the introduction to the 1992 MC, the Committee reiterated this 'view'; see [supram.no. 034](#). Such 'clarifications', being the views of the Committee of Fiscal Affairs' experts on how the earlier versions of the MC or MC Commentary were to be understood, as *Vinelott J.* correctly commented, 'are clearly entitled to very great weight'. Nonetheless, they are **mere**

subsequent comments which were not included in the earlier treaty and therefore cannot be binding for treaty interpretation (see the previous m.no.). In other words, such ‘clarifications’ do not absolve the interpreting parties from determining to what extent the new version actually only clarified what already had been the correctly understood meaning of the earlier MC and to what extent it in fact attempts to alter the MC. In principle there is no difference where a **treaty provision** — as with the Negotiating Protocol (*Verhandlungsprotokoll*) to Germany's DTC with Switzerland of 18 June 1971 — obligates the contracting parties to interpret the treaty according to the standards of the OECD Commentary. This, too, can only be understood to refer to the MC Commentary as is on the date of the agreement, which in the example means only the 1963 MC Commentary. Where a treaty would determine explicitly that the current version of the MC as existing at the time of the treaty application should be controlling, it would have to be examined to what extent the constitutional law of the contracting States permits such a ‘dynamic’ reference. A reference of this type would be a *de facto* authorization for a **non-domestic institution** — the OECD Committee on Fiscal Affairs — to implement **binding domestic** legal measures. This will most probably not be acceptable to most States. However, some changes to the MC or MC Commentary are merely intended to improve the language of the text, or to make the English and the French texts more alike. Many of the changes in 1995 were of this nature. Thus, not every change in the text will have legal significance.

d. Administrative agreements and explanations

[82c] If the contracting States should agree on a particular meaning of a treaty provision following the completion of the treaty, the treaty may be amended or, if necessary, changed. As international law does not require a specific means or form of concluding a treaty, any common expression of the parties' intentions suffices to bind them. **Interpretation agreements** following the mutual agreement and consultation procedures of Art. 25 (see [Art. 25, m.nos. 75, 105](#)) may therefore contain an amendment or possibly a supplement to the treaty to the extent that the competent authorities of the respective States are authorized to conclude such internationally binding agreements. The preceding includes agreements which are in accord with the treaty (thus only confirming a ‘correct’ interpretation), for to determine the correct interpretation with binding effect is not legally different from supplementing the treaty.

However, such amendment to the treaty can be agreed upon implicitly, too, by a common practice of the contracting States carried out with mutual consent. According to Art. 31 (3)(a) and (b) VCLT, subsequent agreements and actual practices in the application of a particular treaty are to be considered upon subsequent interpretations of this treaty when in a similar context. These rules express either something obvious (the view of this commentary), or they refer to events below the threshold of treaty amendments (see, e.g., *Ward, D.A., Treaties, supram.no. 15*, at 31), for which the ensuing observations regarding amendments should apply all the more (*Lang, M., Doppelbesteuerungsabkommen, infra, m.no. 89; id., 38 RIW 573, 575 (1992)*).

[82d] Whether, and under what circumstances, such express or implicit subsequent amendments to a treaty are binding domestically, i.e. whether they have to be respected and applied by courts and other authorities of that state, depends on the **constitutional law** of the particular state. If, according to the constitutional law of the state, international treaties are domestically binding even absent a specified implementation procedure, then this includes interpretive agreements and, where applicable, a binding interpretive practice. The competent authorities can then be viewed as authorized through the treaty article corresponding to Art. 25 (3) to conclude such binding interpretive agreements. It is also conceivable that the constitution indeed requires an implementation of the agreement into domestic law, but that the competent authorities are authorized not only to conclude interpretive agreements, but also to implement them. This seems to be the legal situation in Norway, where the highest court recently confirmed the binding nature of such interpretive agreements (*Høyesterett, Rt. 1401, 1413 (1992)*). If, however, the constitutional law of a state in principle requires, as in most states, the enactment of domestic implementing legislation by the Parliament (see [supram.no. 40f.](#)), the only remaining way to claim binding force for interpretive agreements would be to assume that provisions of the original treaty of the type

comparable to Art. 25 (3) MC may be considered to delegate to the competent authorities the power to enact **derivative domestic legislation** (regulations, *arrêtés*, *Rechtsverordnungen*). But again it depends on the constitutional law of the states in question whether such derivative legislation is admissible and whether its requirements, among them publication, are fulfilled (in Germany this would be the requirements of Art. 80 (1) GG). Normally, they will not, and then the interpretive agreement domestically can mean no more than a legal opinion by administrative experts, i.e. it is not binding domestically (agreeing, *inter alia*, is *Edwardes-Ker*, supra [m.no. 58](#), at 203f.).

[82e] The *BFH* has, therefore, correctly rejected under German constitutional law the binding nature domestically of competent authority agreements (*BFH* BStBl. II 171, 172 (1987): *Germany's DTC with France*; II 253, 255 (1987): *Germany's DTC with the USA*; II 175 (1990): *Germany's DTC with Italy 1925*; *FG Hamburg* 41 EFG 586 (1993): *Germany's DTC with Switzerland*). The Court abandoned earlier jurisprudence which had allowed for the use of a competent authority agreement as a basis for treaty interpretation 'because this explanation given by the contracting parties ... was an expression of their intent' (BStBl. III 212 (1963): *Germany's DTC with Switzerland*). In line with *BFH*, the *ÖStVwGH* (ÖStZB 127 (1992): *Austria's DTC with Germany*; on the laws in Austria in detail, see also *Lang, M.*, supra [m.no. 15](#), at 21ff.) and the Italian *Corte di Cassazione* (Dir. e Prat. Trib. 547 (1989): *Italy's DTC with France*) recently rejected the notion that interpretive agreements were binding domestically under their respective national laws. It is also doubtful, considering that such constitutional rules exist in a majority of OECD States, whether a treaty article corresponding to Art. 25 (3) MC may generally be seen as authorization to conclude a binding agreement. According to this commentary's view, such agreement can bind only the administrative authorities to apply the treaty in accordance with the agreement as long as the courts of the concerned State do not decide otherwise (see, too, *infra* [Art. 25, m.no. 105](#)). See in particular the comments by *Geiger, R.*, *Widman, S.*, and *Pöllath, R.*, in: *Mössner/Blumenwitz et al.*, *Doppelbesteuerungsabkommen und nationales Recht*, 18 Münchener Schriften zum Internationalen Steuerrecht 37, 47, 55 (1995). The question of the binding nature of interpretive agreements is not raised, of course, if the agreement convinces the interpreting court (thus, see *US Court of Claims, Xerox Corp. v. US*, 14 Cl. Ct. 455 (1988)).

[82f] Still greater restraint must be observed with regard to unilateral explanations which the domestic authorities submit following the negotiation of a double taxation convention to the competent parliamentary body during the treaty approval process. In the USA, for example, this would be the '**Technical Explanations**', which the Treasury Department sends together with the text of the agreement to the Senate. It also includes the later report on the treaty of the Senate Committee for Foreign Affairs. Similarly, in Germany there is a '**Memorandum**' (*Denkschrift*), which is submitted together with the draft of the implementing legislation for the tax treaty to Parliament by the Federal Government. Such documents restate only the position of one particular treaty partner. They are therefore seldom 'legislative materials' capable of providing interpretive meaning in the sense of Art. 31 (2)(b) VCLT as they were not 'accepted as a document clarifying the agreement' by the other treaty partner (diverging *Korn/Debatin*, Syst. III, [m.no. 130](#)). Occasionally, however, Technical Explanations have been recognized by the treaty partner before the conclusion of the agreement (see *Déry, J.-M.*, & *Ward, D.A.*, National Reporters, CDFI LXXVIIIa, 259, 271 (1993); *Tax Court of Canada, Coblenz v. The Queen*, 48 DTC 1364 (1994)) and occasionally the German *Denkschrift* has restated the exchange of notes or letters occurring on the signing of a treaty; in such exceptional situations, the contents of these documents will be considered 'legislative materials' in the sense as described above. The degree to which these and other unilateral documents are meaningful in treaty interpretation is the subject of significant discussion by the *ALI Project*, supra [m.no. 1](#), at 30f., 48f.; similarly, *Baker, P.*, supra [m.no. 1](#), at 43.

[82g] In the **past** courts, in the absence of other help, relied more strongly on such unilateral statements made by the authorities of their own State. For instance, the *RFH* designated in several cases an explanation of the *Reichsfinanzminister* on the interpretation of a double taxation treaty as the '**authentic interpretation**' of a treaty ('*authentische Interpretation*') and therefore as binding (StuW 1809, 1810 (1931): *Germany's DTC with Hungary*, RStBl. 878 (1939): *Germany's DTC with Italy 1925*). A Canadian court used a government official as a witness to learn the view of the Treasury Department concerning the interpretation of a particular treaty provision (*Hunter Douglas Ltd. v.*

The Queen, DTC 5340 (1979)), while a US *District Court* relied on the statements of a Treasury official who had served as a witness for the particular treaty issue in question before a Senate Hearing (Corliss v. US, 83-2 USTC 9447). Contrastingly, the *BFH* has tended to be more reserved, as opposed to the *RFH*, in its use of information on the views of the contracting parties provided by the Federal Ministry of Finance. It noted that it will 'not do, merely to use the unilateral subjective position of the German treaty partner as a basis for interpretation' (BStBl. II 605, 606 (1975): *Germany's DTC with the USA 1954/65*; see also BStBl. II 584, 585 (1975): *Germany's DTC with the Netherlands*). The view of the **other** contracting partner will, however, seldom be known.

e. The importance of parallel treaties

- [83] **Literature:** Matscher, F., *Vertragsauslegung durch Vertragsrechtsvergleichung in der Judikatur internationaler Gerichte, vornehmlich vor den Organen der EMRK*, in: *Festschrift für Hermann Mosler 545ff. (1983)*; Vogel, K., *Abkommensvergleich als Methode bei der Auslegung von Doppelbesteuerungsabkommen*, *StbJb 373ff. (1984)*.
- [84] Even where the treaties of a particular State deviate from the OECD or other model, on which they are based, such deviations often are relatively consistent. Negotiators tend to incorporate formulations developed in prior negotiations into subsequent treaties. This may result from the particular interests of the State for which they are acting; it may also result, however, from demands of a new treaty partner. It often occurs, for instance, that concessions made once to a contracting party (say, to a developing country) are demanded subsequently by similarly situated partners and are difficult to deny to them. Thus, each State develops its **own standard formulations**, and incorporates them, parallel to those of the OECD, UN and US MCs, in its negotiations. They are carried forward as needed into subsequent treaties, and, therefore, even if they are not summarized in an independent treaty model (like the US MC), they produce an additional level of continuity in the tax treaties of the respective State. It is, therefore, obvious and — generally speaking — permissible as well, to refer to parallel treaties when interpreting a DTC. Thus, for instance, when interpreting the *USA/Italy* DTC, the *Tax Court* quite properly reverted to the legislative history of the — earlier — *USA/Canada* DTC (*Estate of Burghardt v. Commissioner*, 80 Tax Court 705). Similarly, in *Union Texas Petroleum Co. v. Critchley*, *Harman J.* while discussing provisions of the DTC *UK/USA* drew comfort from provisions of the *UK's DTC with Finland* (STC 691, 700 (1988); confirmed by *Court of Appeal* STC 305 (1990)).
- [85] On the other hand, the use of such standard formulations, as well as of model treaties, should never eclipse the fact that each **individual treaty is autonomous**, that it concerns important and conflicting interests of the two contracting States, and that a coordination of these interests will usually be reached only after difficult and protracted negotiations. As *Harman J.* stated (*loc. cit. supra m.no. 84*) it should be borne in mind 'that the words of the Convention are not those of a regular Parliamentary draftsman but a text agreed upon by negotiation between two contracting governments'. One need only to listen on those rare occasions, usually at a very late hour, when former tax treaty negotiators relate their war stories: stories of delaying negotiations on important issues until the airplane for the return trip is ready to take off, so that the other party is pressed to make additional concessions if the negotiations are to be concluded in the current round; stories of the famous night negotiations, in which the physically robust have the advantage; stories of the host delegation that promised to serve an evening buffet after conclusion of the negotiations, and even arranged the food in an adjacent room in view of the delegations, only to prolong the negotiations mercilessly into the night (according to rumour, the hosts were able to sneak out individually for snacks). Even if ninety per cent of these stories may be comparable to stories told by sailors, hunters or fishermen, enough remains to demonstrate that treaties very often result from stubborn and wily battles in which the negotiating parties are ready, willing and able to make use of every possible advantage. This fact cannot be neglected when interpreting tax treaties.
- [86] In interpreting an individual treaty, therefore, inferences from other treaties into which a contracting State has entered can — in view of the circumstances just described — be drawn only with extreme caution. Differences in the express wording do not necessarily imply that substantive differences are intended. In particular, the absence from one treaty of a rule expressly contained in another treaty does not determine conclusively that this rule does not apply (**no argumentum e**

contrario). It is entirely conceivable that a contracting State in one instance desired a clarification not deemed necessary by the parties to another treaty. It even occurs occasionally that a particular rule is expressly negotiated out of the treaty, but then nevertheless applies through the application of another provision of the same treaty (e.g., it may be intended that particular items of income be excluded from taxation in the State of residence and that the provision referring to them is, therefore, omitted, but that, by means of a catch-all clause corresponding to Art. 21 of all three MCs, the income is still allocated to the State of residence in the end). Such discrepancies can be a result of the tenacity of negotiators on both sides.

[87] The fact that a State's **treaty practice** does not forever remain unchanged must also be taken into consideration when referring to parallel treaties. It is clear that treaty policy changes, as do the particular formulations of treaty provisions used by a State. The meaning of a rule can be derived by reference to a similar or divergent rule in another treaty only if both treaties are considered in the light of the **prior and subsequent treaties** of both contracting States (a good example is contained in a *BFH* ruling made in 1985 and for which the Court — a German Court, it should be recalled — in interpreting a provision of *Germany's* DTC with the *USA*, had recourse to earlier and later DTCs **concluded by the USA**; see 145 BFHE 341 (1985), and for more details regarding that ruling, *infra* Art. 10, at m.no. 35). In addition, it should also be noted that the influence of one treaty on another does not depend on the order in which the treaties enter into force, but rather on the order in which they were negotiated. This order, of course, is often difficult to determine.

[88] Occasionally, it also may be necessary to distinguish between **various types of treaties** negotiated simultaneously by a particular State. For example, with regard to German practice between 1954 and the early 1960s, three types of treaties can be distinguished: those entered into with neighbouring European countries, those entered into during the same period with Anglo-American countries, including the treaty with *Egypt* 1959 and, for unknown reasons, the treaty with *Greece*, and finally, the treaty entered into with *France* which follows a pattern of its own. Currently, although their differences are less radical, German treaties can be divided into those with **Western industrial nations**, those with **developing countries**, and those with countries which were communist at the time of the treaty's signing. The category of a particular treaty may be a determining factor in the interpretation of a provision.

IV. Qualification and Related Problems

[89] **Literature:** See *supra* m.no. 58. Furthermore: Herzfeld, E., *Probleme des internationalen Steuerrechts unter besonderer Berücksichtigung des Territorialitätsproblems und des Qualifikationsproblems*, 6 VjSchr. 422, 456ff. (1932). See also Wengler, W., *Beiträge zum Problem der internationalen Doppelbesteuerung*, 12 (1935); Arendt, W., *Zum Qualifikationsproblem im deutschen internationalen Steuerrecht*, 38 StW 381 (1959); Vogel, K., *Der räumliche Anwendungsbereich der Verwaltungsrechtsnorm*, 279, 311, 325 (1965); Raupach, A., *Der Durchgriff im Steuerrecht*, 135 (1968); Kluge, V., *Die Anerkennung — ausländischer Gesellschaften im deutschen Steuerrecht*, 14 DStR 365 (1976); Vogel, H., *Aktuelle Fragen bei der Auslegung von Doppelbesteuerungsabkommen*, 33 BB 1021 (1978); Vogel, K., *La Clause d'Interprétation de L'Article 3 Par. 2 Modèle de Convention de l'O.C.D.E.*, in: *Réflexions offertes à Paul Sibille*, 519 (1981); Avery Jones, J.F., et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3 (2) of the OECD-Model*, BTR 14ff., 90ff. (1984); Brockway, D., *Interpretation of Tax Treaties and their Relationship to Statutory Law, A US Perspective*, in: *Canadian Tax Foundation, Reports of Proceedings of the 35th Tax Conference*, 619 (1984); Widmann, S., *Zurechnungsänderungen und Umqualifikationen durch das nationale Recht in ihrem Verhältnis zum DBA-Recht*, in: Vogel, K., (ed), *Grundfragen*, 235 (1985); Sinclair, I., et al., *Interpretation of Tax Treaties*, 40 BIFD 75ff. (1986); Sundgren, P., *Interpretation of Tax Treaties — A Case Study*, BTR 286 (1990); Knobbe-Keuk, B., *'Qualifikationskonflikte' im internationalen Steuerrecht der Personengesellschaften*, 37 RIW 306 (1991); Lang, M., *Doppelbesteuerungsabkommen und innerstaatliches Recht* (1992); Ketelsen, H.C., *Kvalifikationsproblemer i forbindelse med grænseoverskridende holdingsstiftelse*, Skat Ud. 247 (1992); Avery Jones, J.F., *Qualification Conflicts: The Meaning of Application in Article 3 (2) of the OECD Model*, *Festschrift Karl Beusch* 43 (1993); Vogel, K., *Tax Treaty Interpretation under the OECD Model*, FTWTR 182 (1993); Piltz,

D.J., Qualifikationskonflikte im internationalen Steuerrecht unter besonderer Berücksichtigung der Personengesellschaften, in: Fischer, L. (ed.), Besteuerung internationaler Konzerne (3 Forum der internationalen Besteuerung 21 (1993)); Xavier, A., Il problema delle qualificazioni nel diritto tributario internazionale, Rivista di Diritto Tributario I (1994).

1. The concept of ‘qualification’

- [90] Special problems arise when a treaty uses legal terms that simultaneously are terms of the substantive law of the contracting States. To refer to these problems, the expression ‘**qualification**’ has come into use, in particular in German literature on international taxation and elsewhere, as a term borrowed from private international law (conflicts law). Tax treaties, however, do not contain conflicts of law rules. They do not provide whether a State must apply domestic or foreign law but rather impose their own distributive rules which are fundamentally different from the conflicts rules of private international law (see *supram.nos. 15ff.*). Consequently, the problems arising when a treaty rule uses terms of domestic substantive law are structurally quite different from the problem of ‘qualification’ as known in conflicts law, and the two should not be confused (concurring *Mössner, J.M., supram.no. 58*, at 420). Admittedly tax treaty problems comparable to ‘qualification’, which are similar to those of private international law (law of the conflicts of law), might arise in the field of double taxation conventions with respect to the determination of the taxes to which the treaty applies (*Vogel, K., supram.no. 89*, at 330). This question, however, is resolved for the most part today through the express listing of these taxes in the treaty itself (Art. 2 (3) of the OECD, UN and US MCs).
- [91] Nevertheless, the term ‘qualification’ as well as the different theories developed to resolve this problem in conflicts law such as the rules of ‘*lex fori*’, ‘*lex causae*’ or ‘autonomous’ qualification, have been adopted, though incorrectly, by literature on international tax law. Its use, therefore, cannot be discarded. But one should be careful at least to use it consistently and in reference to only one **specific type of problem**. In jurisprudence, terms have an ordering function; they allow similar problems to be grouped and enable common rules to be developed. If one sees a ‘qualification conflict’ simply as the situation ‘when two states treat one and the same set of facts differently for tax purposes’ (*Piltz, D.J., supram.no. 89*, at 22), then this opportunity is forgone. Further, the term ‘qualification’ (synonymous with ‘characterization’) has had a relatively constant meaning for a hundred years in private international law (law of the conflicts of law). In tax law there are not ‘qualification’ problems in the specific sense of private international law, so the term should be limited to those problems which are closest to the ones called ‘qualification’ in private international law. Therefore, one should only refer to a ‘qualification problem’ in international tax law for the problem arising when a **tax treaty uses terms derived from domestic law** of the contracting States (especially when the term has a different meaning in the domestic laws of both contracting States). Such terms can be understood according to the law of State A or of State B, or a third interpretation can be applied.
- [91a] In contrast, the issue of how a foreign legal act or a legal institution (of State A) will be treated under domestic law (of State B) is a problem of a different logical structure and is, therefore, **not** strictly speaking a **qualification problem** in the international tax context (regarding this problem, see *infra Art. 1, at m.no. 23*). For example, the issue whether a Venezuelan general partnership or limited partnership (which is a legal person under Venezuelan law) is taxable under the provisions of German income or corporation tax, should not be incorrectly labelled a problem of qualification. Such problems are often called ‘substitution’ in private substantive law (*Lewald, H., Règles Générales des Conflits des Lois*, 132, 134 (1941), reprint from: 49 RC (III, 1939), with examples; *Neuhaus, P., Grundbegriffe des Internationalen Privatrechts*, 351 (2nd. ed., 1976)). The same term could also be applied in international tax law (*Vogel, K., supram.no. 89*, at 330; *Großfeld, B., Basisgesellschaften im Internationalen Steuerrecht*, 62 (1974)). Alternatively, the phrasing of the German *Bundesfinanzhof* could be adopted, which speaks of ‘*Einordnung*’ (classification) under domestic law (BStBl. II 440, 442 (1973)). Furthermore, no problem of qualification arises if a treaty term requires the interpretation of a term that is not a legal term in the law of the contracting State (e.g. sportsmen in Art. 17 OECD and UN MCs). Contrary to what has been suggested (by *Wengler, W., supram.no. 89*, at 13; concurring *Korn/Debatin*, Syst. III, Rdn. 137), exercise of a

discretionary power reserved in the treaty is not a problem of qualification. Finally, **no problem** of qualification exists to the extent that economic transactions or items of property are doubly taxed or exempted — e.g. as taxable objects or deductions — as a consequence of the substantive prerequisites that establish tax liability being defined differently in the two countries involved (a case of ‘economic double taxation’, see *supra* [m.no. 3](#), which is sometimes referred to as a ‘**conflict in attribution**’ (*Zurechnungskonflikt*); for an example, see *SchweizBG*, 51 ASA 497ff. (1983)). In another example, IRS LTR 94-13-005, earnings of a US estate are considered in the USA to belong to that estate, while in Germany the earnings are those of the heir. The double non-taxation, which may arise due to a conflict in attribution, is utilized today, for example, in ‘double-dip leasing’ arrangements.

[92] Some **examples** of the qualification problems addressed in case law may help to define this difficult concept. The following situations raise qualification issues: **(i)** whether remuneration paid to an orchestra conductor for recording is a ‘royalty’ under Art. 12 of the treaty models (as held by *BMF* in *Pierre Boulez*, 83 Tax Court 508 (1984)) or is compensation for personal services under Art. 14 (as held by the *IRS* and *US Tax Court* in *Pierre Boulez*, *loc. cit.*); **(ii)** whether interest paid by a partnership to its partners constitutes business profits of the partners under Art. 7 (as according to the German view, § 15 Abs. 1, 2 *EStG*) or interest under Art. 11 of the treaty model (according to the Swiss view) (*RFH* RStBl. 544 (1939) on *Germany’s* DTC with *Switzerland*); **(iii)** whether severance payments made upon dissolution of an employment relationship — a ‘golden handshake’ — constitute income from dependent personal services under Art. 15 (as under § 19 and § 24 Abs. 2 *EStG*) or income not dealt with otherwise in the tax treaty under Art. 21 (the latter was the prevailing view in Switzerland; more recently, Swiss cantonal law has to some extent changed its position) (*BFH* BStBl. II 757, 758 (1973)); **(iv)** whether a commission agent or trading agent carries on a business within the meaning of Art. 7 (§ 1 Abs. 2 Nrn. 6 and 7 of the *Handelsgesetzbuch* (the German Commercial Code, hereinafter referred to as ‘*HGB*’)) or has income from independent personal services according to Art. 14 (as under Spanish law: *Vogel*, *H.*, *supra* [m.no. 89](#), at 1022); **(v)** whether participation in a real property holding company (‘*Grundstücks-AG*’) constitutes immovable property within the meaning of Art. 6, Art. 13 (1) and 22 (1) (as under Swiss law for the cantonal *Grundstücksgewinnsteuer*, a special income tax) or capital assets (as according to the German view); **(vi)** whether shares of stock issued without payment of consideration, such as stock dividends, constitute ‘income from shares’ according to Art. 10 (3) of the treaty models (as in Austria and Switzerland) or whether they do not constitute taxable income at all (as in Germany, § 8 of the Law on Tax Measures regarding the raising of equity capital out of company funds in the version of 1983); **(vii)** whether interest proceeds of a public limited partnership in the context of a real estate project are income from immovable property in the sense of Art. 6 MC (as the German Finance Administration assumes), or whether they are interest under Art. 11 (as in Austria according to *ÖstBMF* 3 SWI 342, 344 (1993)); **(viii)** whether proceeds received by a majority shareholder for serving as the company’s director are income from dependent services as classified in Germany, whether they are income from independent services as under Austrian legislation (§ 25 Abs. 1 Nr. 1 Buchst. b *öst. EStG*; regarding a competent authority agreement whose compatibility with the DTC is, however, doubtful, see *FinMinBW* of 12 August 1994, 32 DStR 1348 (1994): *Germany’s* DTC with *Austria*), or whether they are ‘other income’ (Art. 21 MC) as under French case law (to this effect see *Conseil d’État*, req. no. 71 227, 21 Dr. Fisc. comm. 106 (1969): *France’s* DTC with *Germany*; Art. 13 (7) of this DTC as amended by the *Additional Agreement 1989* has clarified the latter conflict through a special provision). The above examples are intended only to illustrate the problem.

[93] The literature on double taxation has attempted to systematize problems of qualification by various different methods (see *Wengler*, *W.*, *supra* [m.no. 89](#), at 12; *Spitaler*, *A.*, *supra* [m.no. 1](#), at 555; *Korn/Debatin*, Syst. III, Rdn. 137, follow *Wengler*). These attempts, however, have not been particularly successful.

2. Relation to Art. 3 (2) MC

[94] The problem of qualification can be solved **by the treaty** itself if the treaty defines the particular term expressly (e.g. ‘interest’ in Art. 11 (3) of 1977 OECD MC and UN MC; ‘royalties’ in Art. 12

(2) of 1977 OECD MC and Art. 12 (3) of UN MC) or by reference to the qualification of one of the contracting States (Art. 3 (2); Art. 6 (2) and, to some extent, Art. 10 (3) of OECD and UN MCs). To the extent that the treaty fails to provide an express definition, proposed solutions to the qualification problem are numerous and varied. Commentators, in heavy reliance on the theories developed in private international law and adopting the terminology of that field, have discussed **three possible solutions**:

- **Each State applying the treaty** qualifies the treaty terms according to the requirements of its own domestic law: '*lex fori*' qualification.
- **Both States** qualify treaty terms **consistently** according to the law of the State in which the income arises: **source State** qualification. (This solution is sometimes erroneously referred to as '*lex causae*'. According to the terminology of private international law, however, '*lex causae*' is the legal system that applies to the particular case; in tax law, therefore, the '*lex causae*' is identical with the '*lex fori*'.)
- **Both States** seek to establish a **consistent** qualification from the context of the treaty: **autonomous** qualification (*Wassermeyer, F.*, IStR 49 (1995), uses the same term to mean an interpretation according to the law of the State applying the treaty, a use which deviates from the way the term is generally understood in both international private and tax law, thus creating confusion).

Not previously discussed, but also equally plausible is a **consistent** qualification according to the law of the **State of residence** of the taxpayer.

[95] A **partial solution** to the qualification problem is provided by **Art. 3 (2) MC**. According to this provision, each State shall apply treaty terms as it would according to its own tax law for the taxes to which the treaty applies, unless the context of the treaty otherwise requires (for a more specific account, see *infra* [Article 3 at m.no. 59ff.](#)). However, Art. 3 (2) presumes that a corresponding concept is present in the tax law of the contracting State concerned regarding the actual taxes to which the treaty applies. If an identical term is defined only in tax laws not covered by the treaty, in administrative law or in commercial law, then the provision does not apply, in any case it does not apply directly. One could, certainly, think about applying it by way of analogy. In practice, the case law and a large part of the literature are actually proceeding in this way; often they do not even discuss before whether Art. 3 (2) is directly applicable in the particular case. However, a methodologically correct conclusion by analogy presumes that the adequacy of an analogy is proven beforehand. Therefore, the possibility of analogy to Art. 3 (2) does not diminish the relevance of the question concerning which solution would arise **without the rule of interpretation** provided by Art. 3 (2). And it will be shown later that even for interpreting Art. 3 (2) this question must have been previously clarified. Of course, it must be answered too for the application of treaties that do not contain a provision corresponding to Art. 3 (2) of the treaty models (in regard to Germany, only that country's treaty with *Austria* lacks such a provision).

[95a] The qualification problem is therefore treated in this commentary in two, separate locations: it is discussed **generally** here in the Introduction, and, to the extent that **Art. 3 (2) MC** provides a solution to the problem, *infra* under [Art. 3, m.nos. 57ff.](#)

3. Ways to solve the qualification problem

[96] The starting point of all considerations discussed must be to realize that 'the domestic law on the one hand and the law of double taxation on the other are two mutually independent legal spheres that have their **own boundaries** and definitions'. To the extent, therefore, that an interpretation from the **context** of the treaty, an '**autonomous**' qualification, can be derived, such an interpretation should be given priority if the treaty itself does not define the term (*BFH* BStBl. II 379, 380 (1971); BStBl. II 810, 811 (1973) on *Germany's* DTC with *Switzerland*; see also *RFH* RStBl. 38, 40 (1934) and RStBl. 417, 420 (1934) on *Germany's* DTC with *Italy* 1925; and *BFH* BStBl. III 483, 484 (1966) on *Germany's* DTC with *Sweden* 1959). Courts of other States have decided similarly. Thus, for instance, in a case in which a resident of Italy who was a former chairman of a French company received disguised distributions of profits, the French *Conseil d'État* qualified those payments, for treaty purposes, as being 'other income' within the meaning of Art. 21

MC, rather than as being dividends or directors' fees, and in so doing evidently did not consider this treaty interpretation to present any major problem (*Conseil d'État* req.n. 27.391, 36 Dr. Fisc. comm. 489 (1984) concl. *Bissara*: DTC *France/Italy*). Taxation was accordingly attributed to the State of residence, though coupled with a 'subject to tax clause'. The *Hoge Raad* qualified earnings which under Netherlands domestic law were current or continuous investment income in the particular case as being 'gains from the alienation of property' as meant by Art. 13 MC (*Hoge Raad* Rolno. 25 308 BNB 1991/248, concl. *van Soest*). Further, the *High Court of Australia* gave an autonomous interpretation to the term 'enterprise' in Art. 7 MC in *Thiel v. FCT* (21 ATR 531 (1990)).

[96a] The matter will present difficulties, however, whenever an autonomous interpretation cannot be reached. In early cases of that kind, the German *RFH* adopted the qualification of the **source country** regarding the question as to whether an equity interest or an interest as a creditor is involved, see RStBl. 38, 40 (1934) on *Germany's* DTC with *Italy 1925*; similarly, with respect to the term '*gewerbliche Einkünfte*' (income from a trade or business), see RStBl. 902, 904 (1934) on *Germany's* DTC with *Italy 1925*; and RStBl. 851, 852 (1938) on *Germany's* DTCs with *Czechoslovakia* and *Austria*; still in the same vein, regarding the term '*gewerbliche Einkünfte*' see *BFH* BStBl. III 165, 166 (1964) on *Germany's* DTC with the *USA 1954*; to some extent moreover regarding subsequent payment for 'income from personal services' see BStBl. II 459, 460 (1972) on *Germany's* DTC with *Switzerland*. Recently, *FG Hamburg* affirmed the qualification of a claim for a payment according to the law of the source State, referring to the 'object and purpose' of the treaty at issue, because otherwise a 'negative attribution conflict' would occur (*FG Hamburg*, 41 EFG 10 (1993): *Germany's* DTC with *France*). In a 1938 decision, however, *RFH* gave priority to a qualification according to German domestic law - that is, according to the law of the **State applying the treaty** - for the allocation to the types of income (see RStBl. 852, 853 (1938) on *Germany's* DTC with *Italy 1925*). The German *BFH*, successor of the *RFH*, followed this practice for the most part until the early 1970s. For instance, where Art. 3 (2) of the OECD MC did not apply, regarding a participation in a business enterprise ('*gesellschaftliches Unternehmen*') see BStBl. III 258 (1965) on *Germany's* DTC with *Switzerland*; regarding professional services ('*freiberufliche Tätigkeit*') see BStBl. III 392, 394 (1967) on *Germany's* DTC with *Switzerland*; regarding the terms 'independent/dependent' personal services ('*selbständige / nichtselbständige Arbeit*') see BStBl. II 88, 89 (1972) on *Germany's* DTC with *Austria*; regarding the term 'income from personal services' ('*Einkünfte aus Arbeit*') see BStBl. II 757, 758 (1973) on *Germany's* DTC with *Switzerland*; the interpretation is old, therefore, and is in no way 'progressive', as *Wassermeyer, F.*, IStR 49, 51 (1995), thinks. This corresponds to a trend to be observed in other states as well; namely, resorting to domestic law for the interpretation and, if necessary, for the completion of gaps in a treaty (*Vogel, K., & Prokisch, R.*, [supram.no. 58](#), at 41f.). Canada has even regulated the interpretation of treaty terms by statute (see, *Income Tax Conventions Interpretation Act* of 20 December 1984, *Can. Gaz. Part III* 863; for comments, see *Ward, D.A.*, *Treaties*, [supram.no. 58](#), at 71ff.).

[97] One reason to favour such a qualification according to the **law of the State applying the treaty** ('*lex fori*') is the pragmatic consideration that the authorities and the courts quite naturally understand their own law best. In addition, the old rule of international law, that contracting parties intend to waive their sovereignty only to the extent that this is clearly evidenced in the treaty text, also supports the *lex fori* approach. *Wassermeyer, F.* abstains from this type of justification; he concludes from the **ability** of the contracting States to refer to the domestic law of the State applying the treaty that the intent for such a reference is to be **presumed** if a treaty does **not expressly** define a term (which is by no means conclusive; see, however, *Wassermeyer, F.*, 67 *StuW* 404 (1990)). As an example he refers to the term 'income' (*loc. cit.*, at 405), which, according to the view of this commentary as well, can only be governed by the law of the State applying the treaty (see [infram.no. 101](#)). As further examples he refers to the terms 'enterprise' in Art. 7 MC and 'gains from the realization of property' in Art. 13 MC (*supra*, at 406, 408), for which courts of highest jurisdiction have, contrary to *Wassermeyer*, just recently affirmed an **autonomous** qualification (see [infram.no. 101](#)). *Wassermeyer* himself provides an excellent example for an autonomous (as used in this commentary) qualification of the term 'artiste' in Art. 17 MC, in IStR 555 (1995).

[97a] There is, however, a strong argument **against** an interpretation according to the law of the State applying the treaty: under this solution, the contracting States will **apply the treaty differently**

where the qualifications according to their domestic laws differ. This can lead to continuing double taxation in certain cases where the treaty intended to eliminate it, or it can lead to the opposite result in which neither of the contracting States is allowed to tax a particular event or transaction (Lenz, R., *supram.no. 58*, at 310). For example, double taxation actually resulted where, in case (iii) cited *supram.no. 92*, a 'golden handshake' paid by a German company to its former manager who was resident in Switzerland constituted 'income from services' according to the German view and consequently was taxable in Germany, but constituted 'other income' (as under Art. 21 of OECD MC) under the Swiss view at that time and consequently was taxable there (BFH BStBl. II 757, 758 (1973) on *Germany's DTC with Switzerland*; treatment of the issue is different with regard to subsequent income, see BFH BStBl. II 459, 460 (1972) on *Germany's DTC with Switzerland*, referring to *Locher*). If the company (a German *GmbH*) had been a Swiss company and the manager a resident of Germany, **neither Germany nor Switzerland** would have been entitled to tax the income (*Vogel, K., La Clause, supram.no. 89.*, at 521). Similar consequences resulted from the case law of the *Conseil d'État*, referred to *supram.no. 92* under case (viii), applicable until 1989, regarding the qualification of proceeds received by majority shareholder-directors (double taxation: *Conseil d'État* req.no. 71 227, 21 Dr. Fisc. comm. 106 (1969); double exemption: *Cour administrative d'appel de Paris* req.no. 93-455, 93-456, 46 Dr. Fisc. comm. 1593 (1994), concl. *de Segonzac*: both referring to *France's DTC with Germany*). The presence of 'double non-taxation' due to different qualifications is especially disturbing because residuary double taxation can be eliminated through the mutual agreement procedure (Art. 25 of the MCs) while 'double non-taxation' cannot.

[98] To avoid such undesirable results, *Avery Jones* and his co-authors have argued for qualification according to the law of the **source country** (*Avery Jones, J.F., et al., supram.no. 78*, at 48ff.), and they have attempted to support this approach by an interpretation of Art. 3 (2) which will be discussed in the context of that article (*infra* Art. 3, *m.no. 60*). Qualification according to the law of the source country is provided for in Art. 6 (2) of the MCs covering immovable property and, to a limited extent, although technically somewhat different, in Art. 10 (3) of the MCs covering dividends (see *infra* Art. 10, at *m.no. 199*). The method does in fact lead to a uniform application of the treaty in both States, provided the State of residence is bound by the qualification. However, it certainly does not absolutely avoid double non-taxation (thus, not in the case of the Swedish *Regeringsrätt*, RÅ ref 162 (1987), discussed by *Sundgren, P., supram.no. 89*). Further, it **benefits** the State whose definition extends to **more factual patterns** than that of the other State (*Raupach, A., JbFfSt 354, 356 (1978/79)*). For example, in both variations of the German-Swiss case discussed above of a German company with a Swiss manager or a Swiss company with a German manager, Germany would be entitled to taxation according to the model treaties. If Germany is the source country, it would be entitled to tax under Art. 15, and if Switzerland is the source country, Germany would be entitled to tax under Art. 21. Similarly, in the German-French example with a company in Germany and a majority shareholder-director resident in France, Germany would have been entitled to exclusive taxation under the DTC provision corresponding to Art. 15 MC, in the reverse situation again under Art. 21 (as actually on the one hand *Conseil d'État, supram.no. 92*, and on the other hand *Cour administrative d'appel de Paris* req.n. 93-455, 93-456, 46 Dr. Fisc. comm. 1593 (1994), concl. *de Segonzac*). This advantage to the State applying the broader definition conflicts with the purpose of the treaty which is to distribute taxable events between contracting States equally, and, therefore, source State qualification does not seem suitable as a general solution to the problem of qualification (see, too, *Vogel, K., in: Sinclair, I., et al., 40 BIFD 75 (1986)*, at 78; for further criticism see *Ketelsen, H. C., supram.no. 89*, at 256f.; *Knobbe-Keuk, B., supram.no. 89*, at 309f.).

[98a] Similarly, the rule of Art. 6 (2) necessarily leads to taxation in Switzerland of sales proceeds both with respect to a Swiss real property holding company (case (v) as cited *supram.no. 92*) with German shareholders - if it is assumed that the cantonal qualification of the interests as real property is controlling under the treaty - and with respect to a German real property holding company with Swiss shareholders. In the former instance, Switzerland would be entitled to tax under Art. 13 (1), and in the latter under Art. 13 (4) of the *German-Swiss DTC* in force between 1931 and 1971. So the parties to the treaty decided by mutual agreement to reduce by one half the tax as calculated according to domestic law of each State (with regard to its 1971 DTC with

Germany, Switzerland has recognized that, consistent with the view set forth in paragraph 23 of the 1977 OECD Commentary on Art. 13, profits from the sale of real estate companies are not covered by Art. 13, apparently a case of 'autonomous' qualification; see *Locher/Meier/v. Siebenthal/Kolb*, 13.1 No. 3; *Wetzel, E.*, in: Meyer-Marsilius/Hangarter, Art. 13, Anm. 3).

- [99] Qualification according to the law of the **State of residence** has not previously been discussed. One argument in favour of such a rule, however, is that according to the traditional systematic approach of tax treaties, especially under the OECD and US MCs, taxation in the State of residence is the rule, while taxation in the country of source is the exception (cf. especially Art. 21 of the OECD MC). On the other hand, the possibility of a double residence, which cannot be eliminated in all cases even through application of Art. 4 (2) of the model treaties, remains and in such a case the contracting States must rely on the mutual agreement procedure. This does not appear to be an appropriate means for resolving qualification conflicts. Moreover, qualification according to the law of the State of residence, just like that according to the State of source, would invariably benefit the State applying the broader definition to the term concerned.
- [100] Given the failings of the above three possible solutions, **autonomous qualification** seems to be the only supportable solution. That entails the development of, and where it may already exist, the continued progress towards, an '**international tax language**' superseding national linguistic usage (as the *High Court of Australia* already takes for given in the term 'enterprise' of Art. 7 MC, see *Thiel v. FCT*, 21 ATR 531, 537 (1990); for discussion, see *Vogel, K., & Prokisch, R.*, [supram.no. 58](#), at 27). In fact, it best conforms to the character of the treaty as an independent rule that applies to both States, since only autonomous qualification can guarantee the desired **common interpretation** (see [supram.no. 73](#)) of treaty terms. An autonomous definition **in a treaty**, however, must use undefined terms, which can in turn be subject to qualification. This is illustrated quite clearly in *Pierre Boulez* ([supram.no. 92](#)). Although *Germany's* DTC with the *United States* defines 'royalties' in Art. VIII (3), this autonomous definition was interpreted differently by the German and the US authorities, and double taxation was, therefore, not eliminated. If, on the contrary, it had been the German authorities who had assumed the payments to be income from personal services, and if the IRS had considered them to be royalties, Pierre Boulez would have paid no tax at all.
- [100a] Moreover, States seek to avoid autonomous treaty definitions, in particular because such definitions subsequently restrict their discretion in applying the treaty. Where a term is **not defined**, however, an autonomous qualification must be derived through **interpretation**. This is a difficult task, because sufficient criteria for such a qualification often will be sought in vain. What does the context of the treaty provide for determining whether severance payments constitute income from the rendering of services, or whether the activity of a commissioned agent constitutes business activity or independent personal services? The fact that the contracting States usually want to avoid double non-taxation may be decisive in certain cases (this position is discussed by *Sundgren, P.*, [supram.no. 89](#), at 291). However, this consideration will, as a rule, not assist in determining **which** of the two Contracting States should be limited in its taxation. Even where a federation's constitutional law divides taxing powers among the constituent States, autonomous qualification may prove difficult (an example dating back to 1905: 61 RGZ 28 (1905)). This is true all the more where independent States are involved, and the more diverse the legal systems of the contracting States are, the more desirable autonomous definitions become, but - on the other hand - the more difficult they are to achieve. Even the supporters of autonomous qualification, therefore, resort to the law of the **State applying the treaty** in the end, at least as a **final interpretive solution** ('*Auslegungsbehelf*': *Spitaler, A.*, [supram.no. 1](#), at 563; '*letzte Auslegungshilfe*': *Korn/Debatin*, Syst. III, Rdn. 126; *Debatin, H.*, [supram.no. 69](#), at 480; however, 'only in those rare cases ... , in which the treaty-autonomous interpretation fails': *Lang, M.*, *Hybride Finanzierungen im Internationalen Steuerrecht* 25 (1991); *id.*, 38 RIW 573, 574 (1992)).
- [101] It follows that none of the methods described above is convincing alone. Instead, a **combination of approaches** may work best, with the choice of method dependent upon the purpose for which the interpretation is sought. In this light, the **levels** on which problems of qualification can arise for a distributive rule should be distinguished (regarding these levels, see [supram.no. 48](#)). The different elements of the paradigm distributive rule, as outlined above, may warrant the application of different rules of qualification. For instance, the objections that were raised above against

qualification according to the law of the State in which the treaty is applied ('*lex fori*') are fully valid only on one of these levels (similarly, *Xavier, A.*, [supram.no. 1](#), at 133ff.).

[101a] Within the context of the requirements for application of a distributive rule - that is, the question whether **a person is entitled to treaty protection** - diverse qualification can only lead to the result that the treaty would not apply in one of the two States, and thus that double taxation would not be eliminated. In contrast, double non-taxation cannot occur. Residual double taxation, however, can often, if not always, be eliminated through the mutual agreement procedure, and the other matter of concern, double non-taxation, cannot ensue. Therefore, significant advantages of practicability and legal certainty on this level support a rule of qualification according to the law of the State applying the treaty (this is emphasized by *Spitaler, A.*, in: Lenz, R., [supram.no. 58](#), at 165, 166). On the level of the **legal consequences** of the distributive rule (see also [supram.no. 48](#)), it is just as unlikely that a *lex fori* qualification could lead to double non-taxation. The characterization of the substantive prerequisites which establish tax liability, and to which the rule applies (the '*Objekttatbestand*': '**income**', '**profit**', '**property**', etc.) is even less likely to be based on anything other than the law of the State applying the treaty (see *BFH BStBl. II 569, 571* (1970) on *Germany's DTC with Austria*; the same applies with respect to *Switzerland*, see *SchweizBG 40 ASA 259* (1971/72) on *Germany's DTC with Switzerland*; see also *Philipp, A.*, 55 *DStZ/A* 245, 246 (1967); *Debatin, H.*, [supram.no. 58](#), at 483; *Wassermeyer, F.*, 67 *StuW* 405 (1990); *Lang, M.*, 38 *RIW* 573, 576 (1992)). All this is evident, whether or not Art. 3 (2) is applicable to the particular term (cf., however, *BFH, 28 DB 1107* (1975) on *Germany's DTC with Luxembourg*). The same applies for the question of determining the legal **subject** to which the object of taxation should be attributed (regarding the interpretation of the word 'owns' in the treaty between the *United States* and *France*, see *Rev.Rul. 84-21 I.R.B. 1984-6, 11*; see also 118 *BFHE* 553 (1976), which in turn refers to *BStBl. II 57* (1973) and - incorrectly - to *BStBl. III 397* (1967); for usufruct cases, a (coordinated) decree issued by the *FinMin NRW*, 21 *BB* 1995 (1966), supplies a conciliatory practical solution).

[101b] Only within the scope of the **requirements for the distributive rule**, its '*Metatattbestand*' (see above), is it plausible to argue that qualification according to '*lex fori*' may lead to double taxation or double non-taxation (see the above example, [supram.no. 97](#)). In such cases, all possibilities of deriving an **autonomous** qualification should, therefore, be exhausted. In addition to the context of the particular treaty, treaty practice, the development of treaty terminology, the OECD and UN MCs and Commentaries must be referred to (see, e.g. regarding the concept '*Beteiligung an einem gesellschaftlichen Unternehmen*' (participation in a company) as having been derived from the Austrian *Personalsteuergesetz* (individual income tax law): *BFH BStBl. III 483, 485* (1966) on *Germany's DTC with Sweden*; see, too *BStBl. II 379, 380* (1971) on *Germany's DTC with Switzerland*; furthermore regarding the concept 'income from a source ...' as having been derived from UK's domestic tax law; Sweden's *Regeringsrätt*, RA?ref. 162 (1987); criticized by *Sundgren, P.*, [supram.no. 89](#)). 'In company with the courts of other countries' an autonomous qualification appropriate to the treaty is to be developed step by step 'from case to case' (*House of Lords*, [supram.no. 68](#)), in a 'mutual approach to reconcile carefully and gradually affected legal systems and their judicature' (*Vogel, K.*, La Clause, [supram.no. 89](#), at 523). Until this goal of the development of an **international tax language** ([supram.no. 100](#)) is attained, it will be unavoidable, in certain cases at least, to refer back as a last 'interpretive solution' to the law of the State applying the treaty (the *lex fori*) (see [supram.no. 100](#)).

4. A solution attempted in German treaty practice

[102] In order to reach an acceptable result in both this and certain other cases, recent German treaties often contain a provision which may be most readily illustrated by using *Germany's DTC with Norway 1991* as an example. Prot. para 10 of the treaty states:

'The Contracting States shall avoid double taxation by a tax credit as provided for in paragraphs 1 (b) and 2 (b) of Article 23, and not by a tax exemption under paragraph 1 (a) or 2 (a) of Article 23,

- (a) if in the Contracting States income or capital is placed under different provisions of the Convention or attributed to different persons (other than under Article 9) and this conflict cannot be settled by a procedure pursuant to Article 25; and
 - (aa) if as a result of such placement or attribution the relevant income or capital would be subject to double taxation; or
 - (bb) if as a result of such placement or attribution the relevant income or capital would remain untaxed or would remain exempt from tax in the Federal Republic of Germany or in the Kingdom of Norway; or
- (b) if a Contracting State has, after due consultation and subject to the limitations of its internal law, notified the other Contracting State through diplomatic channels of other items of income to which it intends to apply this paragraph in order to prevent the exemption of income from taxation in both Contracting States or other arrangements for the improper use of the Convention.'

In *Germany's DTC with Norway 1991*, both contracting States have decided in favour of the exemption method (Art. 23 A MC). A similar provision is contained in both the treaties with *Denmark (D)*, Art. 45, and with *Sweden 1992*, Art. 43 (1), in which the other contracting State has chosen the tax credit method (Art. 23 B MC). Other treaties providing for the use of the tax credit method by Germany's treaty partners have a similar provision which, however, only refers to the German side (perhaps because the other contracting State credits anyway). Treaties of this type include Germany's DTCs with: *Canada*, Prot. Nr. 13, *Costa Rica (D)*, Prot. Nr. 5, *India (D)*, Prot. Nr. 6 (c), *Italy 1989*, Prot. Nr. 18, *Mexico*, Prot. Nr. 12, *Mongolia (D)*, Prot. Nr. 3 (b), *Namibia*, Prot. Nr. 4 (b), *Pakistan (D)*, Prot. Nr. 5 b, *Ukraine (D)*, Prot. Nr. 3 (b), *United Arab Emirates (D)*, Prot. Nr. 7, *USA 1989*, Prot. Nr. 21, and *Venezuela (D)*, Prot. Nr. 5. There are small differences in individual points among these provisions, though.

[102a] The first part of the above mentioned rule governs **qualification conflicts** and **attribution conflicts** (for the latter, see [supram.no. 91](#)). However, not all qualification conflicts are covered, rather only those which lead to classifying earnings or capital assets under different distributive rules. Unregulated remain conflicts which concern the place of contact (where a ship has its place of management, where activities are undertaken, etc.) or otherwise concern the precondition or legal consequences of the distributive rules. It is, moreover, unclear whether a conflict must objectively exist in order to apply the rule, i.e. whether the treaty measure is only to be applied if the conflict arises despite the **proper application** of the treaty in both contracting States, particularly through the referral to domestic law, or whether it may be applied whenever the competent authorities are unable to agree on a treaty interpretation. The rule establishes that if the conflict leads to double taxation or double non-taxation, **the exemption method will be replaced by the tax credit method**. That means in the case of *Germany's DTC with Norway 1991*: if double taxation arises as a consequence of the conflict, the State of residence must grant a tax credit, although according to its own, proper treaty interpretation it has exclusive taxation; if double non-taxation arises, the residence State may levy taxes despite the fact that according to its own, proper interpretation it is not so empowered. The treaty provision thus solves the conflict through changing taxation by the residence State.

[102b] If the tax credit method is established for the other contracting State, nothing changes in the application of the treaty provisions discussed here as long as Germany is the State of residence. In a case in the USA in which income was to be taxed as income of an estate, while in Germany as that of the beneficiaries of the estate, the *I.R.S.* correctly referred the beneficiaries to Para 21 of the Prot. *USA 1989* under which they were entitled to a tax credit in Germany (LTR 94-13-005). The result does not change, either, if the other contracting State, which uses the credit method as a basis, is the residence State and double nontaxation is to be avoided. Here the State of residence credits in any event so that double non-taxation does not arise. A transition from the exemption to the credit method thus is not necessary; *Germany's DTCs with Denmark (D)* and *Sweden 1992*, which provide for such a transition in their text, are redundant to that extent. If, however, without the treaty provision discussed here, double taxation were to occur as a result of a qualification or attribution conflict, the general rule according to which the contracting State in question grants

a credit for the other state's taxes (Art. 23 B MC) would not eliminate this double taxation. The reason for this is that the residence State, which according to its (correct) interpretation of the treaty is entitled to levy the taxes in question, would not be obligated to grant a credit under Art. 23 B. Therefore, an additional rule is required, which, though only an exception, prescribes to the residence State a credit which otherwise would not be granted. Such supplementary rules are included in the bilaterally formulated provisions of the DTCs with *Denmark (D)* and *Sweden 1992* (which to that extent are thus not redundant); they are not included, however, in the unilaterally formulated agreements with other crediting States. It is unclear what will govern under these treaties in cases of remaining double taxation. If one does not assume that these treaties to some extent **miss** their goal of avoiding double taxation in conflicts of qualification and attribution, then one must infer, in view of the wording of the particular provision ('... so avoids the Federal Republic of Germany ...'), that Germany, in absolute contradiction to the general system of DTC's, has to grant, **as source State**, the credit. It is difficult to imagine that the German negotiating team intended such an unbalanced result. On the other hand, however, it is hard to see how it can be avoided.

[102c] If, when applying *Germany's* DTC with *Norway 1991*, the qualification of a contracting State, as well as the other's deviating qualification, leads to the result that the other contracting State may levy taxes, but no taxation is established under its domestic law, then para 10 Prot. would be applicable according to its text. It cannot be presumed, however, that the provision shall encroach on the right of the contracting States to decide for themselves whether they want to impose taxes on a particular factual situation or to let it remain tax-free. Para 10 Prot. is thus to be interpreted restrictively; the measure is not a subject-to-tax-clause.

[102d] In addition, the **second part** of the treaty provision, which has not yet been discussed here, contains a **sweeping** clause (except in *Germany's* DTCs with *Canada* and *Italy 1989*): the contracting States are empowered under that clause to apply the credit method instead of the exemption method for other types of income in order 'to prevent the fiscal exemption of earnings in both contracting States or other arrangements designed to abuse the treaty'. This authorization is subject to an established procedure (prior consultation, notification via diplomatic means); beyond that it shall only govern to the extent that the domestic law of the contracting States so permits. The degree to which such permission exists is, at least for Germany, unclear. German Constitutional law demands in general that authorization to interfere with citizens' rights, even to provide for exceptions from favourable regulations, must be 'precise and limited' (BVerfGE 13, 318, 328; see also *Vogel, K.*, HdbStR IV 48). Whether the regulation discussed here complies with this requirement is highly in doubt. It is uncontested, however, that a - narrowly interpreted - abuse clause, as domestic German tax law has established in § 42 AO, is, notwithstanding its vagueness, constitutionally permissible. And according to the prevailing opinion, which is followed by this commentary, double taxation treaties are subject to a general anti-abuse proviso (see in more detail *infra* Art. 1, m.nos. 95f.). To the extent that the clause discussed here does not go further than this proviso, it only provides an adjustment that would govern though with different legal consequences (see *infra*), even without explicit resolution in the treaty. That indeed it does not go further may be concluded from the word 'other'. This word may be understood to imply that double non-taxation triggers the application of the provision only if such double non-taxation results from an 'arrangement designed to abuse the treaty'. Then, the legal importance of the provision would be that an abuse can be claimed only where certain procedural requirements are fulfilled. Moreover, the legal consequence of the abuse would not be taxation as under a non-abusive arrangement, rather it would be a shift to the credit method. With this limiting interpretation the regulation might still be considered as constitutional. Reaching even further, *Germany's* DTCs with *Denmark (D)* and *Sweden 1992*, *supra*, provide for a switch to the tax crediting method after prior notification without limiting this switch to cases of double non-taxation and abuse. Such sweeping authorization is certainly not in accordance with German Constitutional law.

5. Problems of partnerships

[103] Special problems arise with partnerships and other fiscally 'transparent' legal entities with respect to payments to partners, co-partners or beneficiaries in another State if these earnings are

treated differently for tax purposes in the respective States. In this context it may be possible that a particular form of entity is treated in one contracting State as a legal/juridical person for tax purposes while in the other it is not. It may also be the case that a partnership or other entity is not recognized as a taxable entity in either contracting State, however one State allows for a deduction from the entity's earnings of special remuneration to partners while the other State does not. Several authors use the term 'qualification' for these situations as well; however this is once again a problem of an entirely different logical structure. Notwithstanding this reservation, the topic has been discussed in previous editions in this section of the commentary. The present edition of the commentary treats it in [Art. 1, m.nos. 27a ff.](#)

[104-124] [*'International Tax Avoidance' is now discussed infra, [Art. 1, m.nos. 54ff.](#)*]

V. Double Taxation Treaties and Changes to Domestic Law

[124a] Double taxation treaties are designed to endure, at least for the middle-term. The difficult and often lengthy negotiating process generally makes it impossible to amend a treaty following changes made to domestic laws. Therefore, the treaties are created with the intent that they should outlast reforms to domestic law. This is highlighted by Art. 2 (4) MC, which states that the treaties shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the treaty and are in addition to, or in place of, the existing taxes. Likewise, treaties continue to be effective with **the content of their hitherto existing provisions** when other rules of domestic law change. For example, the Swedish *Regeringsrätt* ruled on a treaty provision which confirmed that as under Swedish domestic tax law, taxation as a resident of Sweden continued for three years following one's departure from Sweden. The Swedish legislature had extended the time to five years while the treaty was in force; the *Regeringsrätt* decided correctly that, under the treaty, taxation as a resident during the three year period was still permissible, though beyond the three years it was not (RÅ ref. 37 (1989): *Sweden's DTC with Canada*).

Conflicts, at least problems of adjustment, may arise in three ways through a change in domestic law,

- if the treaty refers to terms or rules of domestic law, and these terms were changed,
- if the new law still corresponds to the wording of the treaty, though no longer to its goal or objective,
- if the new law contradicts the treaty.

1. Reference: static or ambulatory

[124b] **Literature:** Avery Jones, J.F., et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3 (2) of the OECD-Model*, BTR 14, 90 (1984); Sinclair, I., et al., *Interpretation of Tax Treaties*, 40 BIFD 75 (1986); Widman, S., *Zurechnungsänderungen und Umqualifikationen durch das nationale Recht in ihrem Verhältnis zum DBA-Recht*, in: Vogel, *Grundfragen*, 235 ff.; van Raad, K., *1992 Additions to Articles 3 (2) (Interpretation) and 24 (Non-Discrimination) of the 1992 OECD Model and Commentary*, Intertax 671 (1992); Lang, M., *Die Interpretation des Doppelbesteuerungsabkommens zwischen Deutschland und Österreich*, 38 RIW 573 (1992).

[124c] Where a treaty refers to the domestic law of the contracting States, in particular to interpret terms which were taken from the domestic law of the contracting States (see *supra*, [m.nos. 89 ff.](#) and *infra*, [Art. 3, m.nos. 57 ff.](#)), but in other contexts as well, and where this domestic law is changed, the question arises, whether the reference in the treaty points to the law of the contracting States **at the time when the treaty was concluded** (a 'static' interpretation) or to the law **at the time when the treaty is applied** (an 'ambulatory' interpretation). The question has thus far been principally discussed in the context of Art. 3 (2) MC. It is equally relevant, however, for other references in the treaties, both explicit (e.g., by Art. 6 (2) MC) and implicit. Until the early 1980s the static/ambulatory alternatives had not been considered to be a problem. References to the domestic law were thought to refer to the **law as it currently stood**, and the issue was rarely discussed further (see Lenz, R., General Reporter, CDFI XLII 294, 297 (1960); US Rev. Rul. 80-243, 1980-36, 32). Differing opinions found no resonance (for example, Rivier, J.M., *supra* [m.no. 1](#), at 105). Then,

however, a Canadian case led to a more in-depth debate when, in contrast to the ideas prevailing at the time, the Canadian courts under the reference to domestic law in Art. 3 (2) MC applied the relevant Contracting State's **law as it stood at the treaty's signing** (The Queen v. Melford Developments Inc., *Court of Appeals*, 35 DTC 5020 (1981); *Supreme Court*, 36 DTC 6281 (1982)).

[124d] This static/ambulatory issue has been discussed extensively and convincingly in a project of the 'International Tax Group' under the leadership of *Avery Jones, J.F.* ([supra m.no. 124b](#)). In support of the view of the Canadian court and its static interpretation, it might be said that a reference to the domestic law as amended gives the contracting States, through changing their domestic law, the opportunity to alter the scope of an international obligation. However, in some instances it will be extremely difficult to ascertain under older double taxation treaties exactly how the terminology of the domestic law was to be understood at the time of the treaty's signature. A poignant example is *Germany's DTC with Italy 1925*, which was still operational until very recently (1989). Further, there are treaty provisions in DTCs which are only meaningful if interpreted through a non-static (i.e. ambulatory) perspective, such as Art. 10 (3) of all three model treaties. Thus, the traditional view, that reference is to be made to the domestic law **as amended** (ambulatory), should be preferred. See also on this topic: *Brockway, D.*, in: Canadian Tax Foundation, Reports of Proceedings of the 35th Tax Conference 632 (1984); *Klebau, B.*, 31 RIW 125, 129 (1985); *Langbein, V.*, 30 RIW 531, 539 (1985); *id.*, Intertax 4, 6 (1987); *id.*, 34 RIW 875, 878 (1988); *Sinclair, I.*, [supra m.no. 124b](#), at 81; *Widmann, S.*, [supra m.no. 124b](#), at 242; *Vogel, K., & Prokisch, R.*, [supra m.no. 58](#), at 48.

[124e] An **ambulatory** interpretation is now explicitly called for by the **MC Commentary 1995** (see Art. 3, paras 11 ff.; [infra Art. 3, m.nos. 56 ff.](#)) when the context does not require otherwise. Since 1992 the MC Commentary has supported the use of an ambulatory interpretation; it points out correctly, however, that from the context of the treaty provision concerned, a different result can occur in individual cases. It also notes that there are two competing interests of the contracting States opposed to one another: the desire for a durable, lasting rule and the necessity for one which is also practicable. What the MC Commentary further adds to explain the term 'context' is, unfortunately, unclear (see *van Raad, K.*, [supra m.no. 124b](#)). In Canada the problem was settled in the meantime through a statute adopting the 'ambulatory' interpretation (Income Tax Conventions Interpretation Act of 20 December 1984, Can. Gaz. Part III 863). For *Germany's DTC with Austria, Lang, M.* holds the view that particularities of this DTC - the identical legal terms of both States as well as the lack of a provision corresponding to Art. 3 (2) - suggest a static interpretation for particular terms (*Lang, M.*, [supra m.no. 124b](#)).

2. Infringing on the objectives of Double Taxation Conventions ('Treaty Dodging')

[125] Much as taxpayers arrange their legal relationships to decrease their taxable income or to even eliminate tax liability (i.e. they use tax planning), **legislatures** too, by appropriate formulation of new legislation are able to increase the benefits of existing tax treaties for their national tax coffers while decreasing the disadvantages. This practice does not happen every day, it is true. Not infrequently, though, legislation is enacted with at least a view towards existing tax treaties (*Rigby, M.* discusses 'Treaty Abuse' by governments in 8 Australia Tax Forum 300, 416, 421 (1991); the details of his conclusions, though, in the opinion of this commentary, go too far). One opportunity, but not the only one, to improve a State's legal situation under a treaty comes from the ambulatory reference to domestic law: through a change of its domestic laws a contracting State is able to broaden the scope of circumstances which it is allowed to tax under a treaty. Whether such result is the purpose of a legislative change or whether it is an unintended side-effect of changes occasioned by other reasons cannot always be determined. This was exactly the ground why the Canadian courts supported a static interpretation of the reference to domestic law in the Melford case ([supra m.no. 124c](#)). Another opportunity arises from the flexibility of technical legal formulations: if one potential formulation of a law leads to undesired consequences under existing treaties, a legislature may look for a legal 'dress' which, at least according to its wording, does not give rise to the same undesired treaty consequences. Conversely, new legal relationships may be created artificially by legislative action if they seem to be advantageous under the treaty.

- [125a] Such legislation may indeed not contradict the wording of the relevant treaties, however it does infringe on their substantive contents (*Kingson, C.*, Columbia Law Review 1151 (1981)). Thus, *Avery Jones* and his co-authors have supported the ambulatory reference only with an '**implied limitation**': 'without impairing the balance or affecting the substance of the convention' (*Avery Jones, J.F., et al., supra, m.no. 124b*, at 48). A possible abuse is avoided here through an adequate interpretation of the treaty expression which refers to domestic law. Their view should be followed (those who are cited above, *supram.no. 124d* agree). However, not every infringement of the substantive contents of a treaty can be averted by such a means.
- [125b] Legislation and case law combat the construction by private persons of legal arrangements, created without a rational business purpose, designed exclusively for the avoidance of tax consequences as '**abuse**', '*abus de droit*', '*fraus legis*', '*Mißbrauch*' or similar terms (see [Art. 1, m.nos. 78 ff.](#)). A State acting correspondingly infringes on its international legal duty to fulfil the treaties which it concluded **in good faith** (Art. 23 VCLT). However, the standard international sanctions against treaty infringements may not be readily applied to such behaviour. They are styled on the 'breach' of a treaty (Art. 60 VCLT): the open contravention or nonfulfilment of a dutifully owed obligation. In the type of cases discussed here, in contrast, the treaty is not actually 'broken'. Rather, attempts are made to 'circumvent' or to 'dodge' the treaty. The sources of international law, however, are not to be found exclusively in the conventional rules of the VCLT and in international customary law. According to Art. 38 (1) (c) of the Statute of the International Court of Justice, they include **general legal principles** recognized by civilized nations. This concept refers to the common principles of internal law covering private persons; as principles of international law, they are similarly binding on States too. One such principle is the nearly universal rule that legal acts undertaken absent good faith are to be disregarded. A more concrete version embodied in the tax systems of most developed States is that artificial arrangements obviously motivated by tax considerations only and without any reasonable business purpose **are not recognized under fiscal law**: in such cases the 'substance' of the transaction is considered instead of its legal 'form' (see *infra* [Art. 1, m.nos. 78 ff.](#) for discussion on the differences and use of these terms). Being a 'general legal principle', this rule also governs the legal relations of States with one another. Thus, if a State attempts to evade its tax treaty responsibilities, those legal consequences which would have resulted from a *bona fide* legislative construct are considered to have occurred instead of the legal consequences brought about by the 'artificial' legal structure.
- [125c] For example, if income of a foreign **subsidiary**, which ordinarily would fall under Art. 10 of the MCs upon distribution to the parent corporation, is deemed by domestic law to constitute income **of the parent company** prior to such distribution and is taxed as such, the obligation to handle this forestalled dividend taxation according to the applicable treaty cannot be altered (correctly, *Rigby, M.*, 8 Australia Tax Forum 301, 333 (1991)). If domestic tax law treats interest paid to a shareholder as dividends, such a rule will apply for treaty purposes only if the treaty rule for interest is limited to those loans that under the circumstances may be viewed as 'real' rather than as disguised capital contributions. The domestic legislature, it is true, can overrule treaty provisions; such legislation will then be binding on the domestic courts (different rules apply, as was mentioned before, with regard to the Netherlands as a consequence of the monistic view adopted by the Netherlands constitution). It can do so, however, only by violating international law, thus risking reprisals which the other contracting State could undertake in conformity with international law to defend its contractual rights. (A similar result is reached by *Avery Jones* and his co-authors, *supram.no. 79*, at 47, by advocating an 'implied limitation' to the 'ambulatory interpretation' of treaty terms; concurring *Brockway, D.*, *supram.no. 35*, at 635; the 'static interpretation' as advocated by the *Canadian Supreme Court* in *Melford* would even bind the contracting State to a much higher degree; see D.T.C. 6218 (1982).)
- [126] According to Art. 31 (3)(b) of VCLT, however, reference must also be made, in interpreting a treaty, to the subsequent practice of the parties (see *supram.no. 82a*). Consequently, if the other contracting State has accepted the application of the new law for some period of time, the avoidance objection no longer can be raised. It is, therefore, unnecessary today to examine whether the Subpart F legislation of the US Internal Revenue Code or the German '*Au #ensteuergesetz*' are reconcilable with the double tax treaties the United States and the Federal Republic of Germany had previously concluded (with regard to the discussion at the time when

Subpart F was enacted, see *Mutén, L.*, 49b CDFI 1 (1964)). Moreover, with regard to Germany, Agreed Minutes between Germany and Switzerland of 29 September 1971 expressly stress that the tax treaty between *Germany and Switzerland* does not prohibit the attribution of profits among controlled corporations.

3. Treaty override

- [127] **Literature:** *Rezek, J.F., Lüthi, D., et al., Tax Treaties and Domestic Legislation, 43rd IFA Congress, Rio de Janeiro, Seminar B (1989); Eilers, S., Override of Tax Treaties Under the Domestic Legislation of the U.S. and Germany, 19 TMI 295 (1990); Doernberg, R., Selective Termination or Suspension of Income Tax Treaty Provisions, 2 TNI 1130 (1990); Metzger, D., Verträge sind einzuhalten - auch im internationalen Steuerrecht, 59 ASA 13 (1990/91); Schoueri, L.E., Validade de normas internas contrárias a dispositivos de acordos de bitrib# tãção no direito e na prática norte-americana, 3 Revista dos Tribunais 147 (1993); Mössner, J.M., Rechtsschutz bei Treaty Overriding, in: 3 Forum der Internationalen Besteuerung 113 (1993); Leisner, W., Abkommensbruch durch Außensteuerrecht? 39 RIW 1013 (1993); Sundgren, P., Efterlernad av traktater, Skattenytt 461 (1995); Vogel, K., Abkommensbindung und Mißbrauchsabwehr, in: Festschrift Ernst Höhn (1995). OECD Committee on Fiscal Affairs, Tax Treaty Override (1989) (also published in 2 TNI 25 (1990)).*

a. Legislative practices

- [128] A legislature amending its nations' domestic tax laws may find it desirable to **alter** the current double taxation treaties to comply with the objectives of the new measures. It could then compel the competent political authority to commence negotiations in order to change the treaty, or, if necessary, to terminate the treaty (see *infra* Art. 29/30, m.nos. 22ff.). Occasionally, the contracting States to a DTC expressly bind themselves to conduct new negotiations aimed at amending the treaty following a fundamental change in the domestic tax law of one of the States; in particular the USA have recently attached importance to including such provisions in its treaties (since the *DTC USA/Spain* 1990). However, when a legislature unilaterally enacts new domestic tax laws which are contrary to an existing treaty without the treaty having been amended or terminated, such legislative action is then a **violation** of the treaty under **international law**. This type of treaty-violating legislation has become known as a '**Treaty Override**'. The *Committee on Fiscal Affairs* of the *OECD* defines the treaty override as 'the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations' (*OECD, supram.no. 127*, Nr. 5). A 'harmless' treaty override, i.e. one which remains under the threshold of a violation of international law (see *Bartlett, R.T.*, BTR 76, 83 (1991)), is not conceivable under this definition.
- [129] In 1980 the US Congress affirmed its intention to violate tax treaty obligations with unusual frankness. The Foreign Investment in Real Property Act (FIRPTA) provided that some of its particular provisions, to the extent that they contradicted existing treaties, be suspended for the first five years following passage, but thereafter would become effective **without regard to contradicting treaties**. Since then, the topic of the 'tax treaty override' has often been raised in the USA when tax-related legislative measures have been at issue. Particularly intense discussions in this regard arose concerning the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), which was intended in part to clarify the compatibility of certain provisions of the Tax Reform Acts of 1986 and existing treaties (see *Sanderson Schadé, R.*, 43 BIFD 214 (1989); for discussion of this controversial question at the time, see also: *Forry, J., & Karlin, M.*, 35 TN 793 (1987); *Langbein, V.*, 34 RIW 875, 876ff. (1988)). While Congressional debates about this act were still under way, ten of the twelve EC Member States expressly protested against, among other things, an infringement of existing DTCs in a common letter of 18 February 1988 (*Bartlett, R.T.*, *supram.no. 128*, at 83). In a 1990 hearing of the Senate Foreign Relations Committee, US Senator *Sarbanes* expressed doubts that a treaty override by the USA was really a treaty violation because 'the parties entering into these treaties know, and full well, that Congress has been prepared to override these tax treaties, and therefore they go into them with that knowledge' (47 TN 1418

(1990); rejecting this view is the Chairman of the Finance Committee (*Finanzausschuss*) of the German *Bundestag*, *Gatterman, H.*, 2 TNI 1238 (1990); a recent decision by the *BFH*, see [infram.no. 135](#), is also questionable).

[130] However, there are others in the USA as elsewhere who are firmly critical of this tendency of some Congressmen and Senators to champion treaty overrides. This other side includes the Treasury Department and prominent authors in the field (see, *inter alia*, the ALI Project II, [supram.no. 1](#), at 73ff.). While debating the TAMRA legislation, Congress seriously endeavoured to keep within the framework of existing DTCs; the remaining differences of opinion were over questions of treaty interpretation (*Senate Finance Committee* Report No. 100-455, 100th Cong. 2d Sess. (3 August 1988) to accompany P. 2238; it is also found in 1 TNI 602 (1989)). In other States, efforts to enact treaty overriding legislation are, as a rule, not so openly discussed. The true intention of such legislation may easily be concealed or shaded, in particular because there may indeed be different legal opinions with regard to whether a particular measure is contrary to a treaty or not. Thus, a legislature that wishes to be released from a long-term treaty commitment may pretend to be faithful to the treaty and, where possible, even to do so in good conscience. However, if a bill **contradicts** a longstanding interpretation of a treaty **which had never previously been contested** and the bill is claimed to only 'clarify' the meaning of the treaty, there is every indication that in reality nothing less than a 'treaty override' has been intended. It is also suspect when legislation is supposed to merely rectify the result of an allegedly incorrect **judicial decision**. Occasionally, such a law may really be intended to only restore the true meaning of a treaty (as happened, in the view of this commentary, with the Canadian decision in the Melford case, see [supram.nos. 124c, 124e](#)). However, this is very unlikely when such 'corrections' are undertaken **more frequently** (as in the *UK* subsequent to the decision of the *House of Lords* in *Dawson v. IRC*, STC 473 (1989) [through the Finance Act of 1989, sect. 110], as well as retroactively subsequent to the decision of the *Court of Appeal* in *Union Texas Petroleum Co. v. Critchley*, STC 691 (1988) [through the Finance Act of 1989, sect. 115], and even still during a pending decision in *Padmore v. IRC*, 62 Tax Cases 352 (1993) [through the Finance Act (No. 2) 1987, sect. 26]; see, regarding this issue, *Williams, D.W.*, *Intertax* 298 (1990)). Contrary to the view of the OECD Committee on Fiscal Affairs ([supram.no. 127](#), at no. 4a) such adjustments may certainly be **hidden treaty overrides**. Characteristic is the statement of a British *Financial Secretary* in another case in which the *Special Commissioners* had already decided against the government: 'We are now using this Bill to change the law to what we thought it was and to reflect the double taxation treaty' (*House of Commons*, 30 June 1992, at 452).

[131] Occasionally, attempts are made at justifying legislation which is contradictory to a treaty by claiming that this legislation only prevents **abuses** of the treaty and therefore does not contravene the proper meaning of the treaty at all. A German example of this practice is seen in the changes to §§ 10 and 20 *AStG* by Art. 17 of the 1992 Taxation Amendment Act (*Steueränderungsgesetz*) from 25 February 1992 (BGBl. I 297). According to § 20 Abs. 2 and 3 of the amended law, if a German resident receives income that ordinarily would be exempt from German taxation under a DTC through a non-German permanent establishment, and if this income is of a 'capital investment character', the exemption provided for by the treaty is replaced by a tax credit in Germany. Further, under § 10 Abs. 6 of the amended law, similar income of foreign subsidiaries is to be added to that of the German parent and taxed with it in Germany even where dividends distributed by the subsidiary to the parent would be tax exempt under a DTC. These rules were prompted by the investment of significant amounts in Ireland due to an advantageous tax rate on certain capital investment companies (*Kapitalanlagegesellschaften*) there - an investment incentive which has been approved by the EC Commission. Whether the new law for subsidiaries (§ 10 Abs. 6 *AStG*) is contradictory to existing DTCs depends on whether an exemption for distributions paid by a foreign subsidiary to its German parent (participation exemption) as established under treaty law also governs additions made under *AStG* (*Hinzurechnungsbetrag*), and is contested (see also [infraArt. 10, m.no. 219](#)). The German legislature had previously respected the participation exemption and had not provided for taxation in these types of cases (§ 10 Abs. 5 *AStG*). This commentary, as well as many authors, has consistently maintained that such treatment is required under existing treaties as additions under *AStG* are dividends in the sense of treaty law (see [infraArt. 10, m.nos. 219ff.](#)). Thus, it is maintained here that the new German legislation is contrary to existing treaties

(*Vogel, K.*, Handelsblatt of 9 December 1991; those agreeing include: *Leisner, W.*, [supram.no. 127](#), at 1013; *Ritter, W.*, 47 BB 361, 364 (1992); *Schwarz, H.*, & *Fischer-Zernin, J.*, 38 RIW 49 (1992); *Taniguchi, S.*, 2 S#g#-Zeisei-Kenki# 112 (1993); differing is *Mössner, J.M.*, [supram.no. 127](#), at 127f.). Further, even if one does not share the view that the additions under AStG are ‘dividends’, it is clear that at least the new provision for permanent establishments is an obvious impairment of the applicable treaty and is therefore a treaty override (agreeing, among others, are *Schwarz, H.*, & *Fischer-Zernin, J.*, *loc.cit.*; see also *Vogel, K.*, *loc.cit.*).

- [132] To justify the new legislation, the German government and *Bundestags-finanzausschuß* (Finance Committee of the *Bundestag*) asserted that it serves to **combat treaty abuse**; they argued that treaties must **not be used abusively** (citation offered by *Tulloch, A.*, 45 DB 1444, 1445 (1992); see also *DOX 74 FR 130* (1992), as well as *Debatin, H.*, 45 DB 2159, 2163 (1992), on the latter's confused arguments regarding constitutional and international law, see *Mössner, J.M.*, [supram.nos. 127, 132f.](#)). The principle referred to is stated correctly (see [infraArt. 1., m.nos. 76ff.](#)); however, it presupposes that an abuse is shown **in the particular case under scrutiny**. *Leisner, W.*, has convincingly established that the investments in Ireland were not abusive (see previous m.no.). Further, it is **doubtful** whether a **law**, i.e. a general rule that does not only refer to individual cases, may in any event be based on this concept. The OECD Committee on Fiscal Affairs has declared itself against treaty overriding legislation, even in cases of combating abuse (OECD, [supram.no. 127](#), Nr. 34). If legislation of this type is to be recognized at all under international law, it must clearly snare only those particular cases in which an individual application of the abuse concept would be justified. Such legislation is the new German regulation of § 50d Abs. 1a *EStG* (see [infraArt. 1, m.no. 100](#)), and the same may possibly be true for the ‘classic’ Swiss Anti-Abuse Decree (*Mi #brauchsbeschlu #*) of 1962 (see [infraArt. 1, m.no. 99](#)). The latter issue, however, remains open.

b. Legal consequences of a ‘Treaty Override’

- [133] A treaty override, being an infringement of an international obligation (by definition, [supram.no. 128](#)), gives the treaty partner the right to invoke sanctions. Specific sanctions in response to treaty violations are provided by Art. 60 VCLT. These include the possibility of terminating the treaty or of suspending its operation (regarding sanctions, see *Doernberg, R.*, [supram.no. 127](#), at 1130, who recommends a limited termination or suspension). Corresponding retaliatory measures are also an acceptable response to a treaty violation. The United Kingdom and other countries have threatened the USA with such measures in response to ‘unitary taxation’ (see [infraArt. 9, m.no. 17](#)), though this is not a controversy governed by treaty law (see *Turro, J.*, 7 TNI 75 (1993); *de Hosson, F.C.*, Intertax 578 (1993)). *Kergall, Y.*, Intertax 458 (1993), addresses the question of when a treaty override is void under EC law.
- [134] The violation of international law, however, **does not necessarily** lead to the invalidity of the treaty-violating **domestic** law. Rather, this is a question dependent upon the particular State's **constitutional law**. According to Art. 55 of the French Constitution from 1958, effectively concluded treaties have primacy from the moment of their publication over standard domestic laws (the previously contested question between the *Conseil d'État* and the *Cour de Cassation* of whether a court may disregard the application of a treaty-violating statute has in the meantime been unanimously affirmed). A similar provision is contained in Art. 94 of the Netherlands Constitution. Article 98 (2) of the Japanese Constitution is also interpreted in the same way. In Belgium, too, international treaties prevail over domestic law (*Cour de Cassation*, J.T. 471 (1971)). In Switzerland the question is not definitively clear; the *SchweizBG* had earlier denied the primacy of a treaty (BGE 59 II 331, 337), though recently it limited this ruling to cases in which the Federal legislature deliberately intended to depart from the treaty (BGE 99 I b, 43). But even this is contested in legal literature (see *Metzger, D.*, [supram.no. 127](#)).
- [135] In most States, however, treaties **do not prevail** over other legislation. Domestic laws which are **later in time** than **earlier** treaty-implementing legislation (see [supram.no. 42](#)), even if infringing upon international law, **may deviate from the treaty** (‘*lex posterior* rule’, or ‘later in time rule’). In the USA, for instance, international law is ‘the supreme law of the land’ under Art. VI cl. 2 of its Constitution. From this it follows that international treaties have priority over the law of the

individual states. However, as a treaty is equivalent to other Federal legislation, it also means that a later Federal law can invalidate or violate a treaty, and this later law will have binding effect domestically (*Supreme Court, Whitney v. Robertson*, 124 US 188, 190 (1888)); see, among others: Restatement of the Law Third, [supram.no. 7](#), § 115 Comment and Reporter's Notes; *New York Bar Association* 37 TN 931 (1987); *Vogel/Shannon/Doernberg/van Raad*, Pt. I: Overview, 1. 2. 2. 3.; *Brecher, S.M.*, The Tax Executive, 179ff. (1972); *Langbein, V.*, 30 RIW 535 (1984); *Eilers, S.*, [supram.no. 127](#)). In Germany the same result is inferred from Art. 25 GG, according to which 'general rules of international law' have primacy over Federal laws, which excludes treaties. It is true that § 2 AO states: 'Treaties with other States in the sense of Article 59 Abs. 2 Satz 1 of the Basic Law (*Grundgesetz*) that address taxation, to the extent that they have become directly applicable under domestic law, take precedence over other tax legislation'. However, as this provision is only an ordinary Federal statute, it is unable to award to treaties a higher rank than that of other ordinary laws (dissenting, however, is *Eckert, R.*, RIW 386 (1992)). Further, there has been consensus for decades (see, *Mössner, J.M.*, [supram.no. 127](#), at 122f.; *Scherer, Th.*, Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht, 30ff. (1995); dissenting, *Wohlschlegel, H.P.*, 75 FR 48 (1993)), that the international rule '*pacta sunt servanda*', despite belonging to general international law in the sense of Article 25, cannot establish a position for treaties which would be superior to that of ordinary legislation (as it was found again by *Eckert, R.*, 38 RIW 386 (1992)). Whether, however, this traditional interpretation of Art. 25 GG is still suitable today should be reconsidered. In any case, domestic legislation that violates a treaty is not 'lawful', as the *BFH* claimed in a recent decision (*BFH BStBl. II 129* (1995): *Germany's DTC with Poland*); it remains a violation of international law, is therefore illegal and if need be is at best (or better: at worst) domestically binding. In the UK, treaties in general are not considered to have a binding effect on the domestic level, rather it is the implementing statute (or order in Council) that may be binding. Therefore subsequent legislation is considered able to alter or negate such statute or order (for example, through a comprehensive tax reform: *Privy Council, Woodend Rubber Co. v. C.I.R.*, 3 W.L.R. 10, 19 (1970)).

[135a] **Not every** later law preempts a previously concluded treaty, however. For it is recognized in all the States discussed here, as well as in others, that a later **general** law does not in principle supersede an earlier **special** one to the extent that the later law does not expressly state its superiority to the earlier one and that such intention cannot be inferred, as well, in any other way. **Double taxation treaties**, in particular, have been found in judicial decisions to be special laws in relation to general legislation: the courts are attempting, therefore, to avoid violations of international law where possible and to align the national laws with international ones. In Germany, the previously cited § 2 AO establishes the position of double taxation treaties as special legislation in relation to general tax laws. A corresponding rule (at least) governs in Switzerland according to *SchweizBG* E 94 I 669, 678. For Austria, compare *ÖstVwGH* Erk. Slg. Nr. 2907 (F)/1963, Nr. 2907 (F)/1983; regarding this issue, see *Lang, M.*, *Finanzjournal* 72 (1988); for the UK: *Salomon v. Commissioner of Customs and Excise*, 3 W.L.R. 1223, 1233 (1966).

VI. Double Taxation Treaties and European Law

[136] **Literature:** *Lehner, M.*, *Möglichkeiten zur Verbesserung des Verständigungsverfahrens auf der Grundlage des EWG-Vertrages (Münchener Schriften zum Internationalen Steuerrecht*, 4), 1982; *Hamaekers, H.*, *Corporate Tax Policy and Competence of the European Community: An EC Tax Convention with Non-Member States?* 30 ET 358 (1990); *Claeys Bouúaert, I.*, *La règle de non-discrimination dans la jurisprudence fiscale de la Cour de Justice Européenne*, *Journal de droit fiscal* 257 (1991); *Hahn, H.*, *Berührungspunkte zwischen europäischem Recht und dem innerstaatlichen Recht der direkten Steuern*, 80 DStZ 663 (1992); *Heithuis, E.J.W.*, *Europees belastingrecht in relatie tot de bilaterale belastingverdragen vanuit Nederlands perspectief*, 122 WFR 1649 (1993); *Berlin, D.*, *Trends in the Tax Jurisprudence of the Court of Justice of the European Community*, *EC Tax Rev.* 80 (1993); *Vogel, K.*, *Harmonisierung des Internationalen Steuerrechts in Europa als Alternative zur Harmonisierung des (materiellen) Körperschaftsteuerrechts*, 70 StW 380 (1993); *id.*, *Taxation of Cross-Border Income, Harmonization and Tax Neutrality under European Community Law (Foundation for European*

Fiscal Studies, 2) (1994); Vedder, C., *Einwirkungen des Europarechts auf das innerstaatliche Recht und auf internationale Verträge der Mitgliedstaaten: die Regelung der Doppelbesteuerung*, in: Lehner, M., Thömmes, O., et al., *Europarecht und Internationales Steuerrecht (19 Münchener Schriften zum Internationalen Steuerrecht, 1)* (1994); Lehner, M., *Europarechtliche Perspektiven für das Internationale Steuerrecht (19 Münchener Schriften zum Internationalen Steuerrecht, 19)* (1994); Thömmes, O., *Europarechtliche Probleme aus der Praxis des Internationalen Steuerrechts (19 Münchener Schriften zum Internationalen Steuerrecht, 29)* (1994); Wiedow, A., *Steuerharmonisierung bei den direkten Steuern: Stand, Perspektiven, Auswirkungen auf Doppelbesteuerungsabkommen (19 Münchener Schriften zum Internationalen Steuerrecht, 45)* (1994); Hinnekens, L., *Compatibility of Bilateral Tax Treaties with European Community Tax Law, The Rules*, *EC Tax Rev.* 146 (1994); Lehner, M., *Auswirkungen der Steuerharmonisierung auf das Recht der Doppelbesteuerungsabkommen*, in: Birk, D., & Ehlers, D. (eds.), *Rechtsfragen des europäischen Steuer-, Außenwirtschafts- und Zollrechts* 18 (1995); id., *Die Beseitigung der Doppelbesteuerung innerhalb der Gemeinschaft, A. Einführung*, in: Birk, D. (ed.), *Handbuch des Europäischen Steuer- und Abgabenrechts* 903 (1995); Scherer, Th., *B. Allgemeine Vorgaben des Gemeinschaftsrechts für den Abschluß von Doppelbesteuerungsabkommen, C. Einzelprobleme*, in: Birk, D. (ed.), *Handbuch des Europäischen Steuer- und Abgabenrechts*, 943 (1995); id., *Doppelbesteuerung und Europäisches Gemeinschaftsrecht* (1995); van Raad, K., *The impact of the EC Treaty's Fundamental Freedoms Provisions on EU Member States' Taxation in Border-crossing Situations - Current State of Affairs*, *EC Tax Rev.* 190 (1995); Hinnekens, L., *Compatibility of Bilateral Tax Treaties with European Community Law - Applications of the Rules*, *EC Tax Rev.* 202 (1995).

1. Sources of the law

[137] When double taxation treaties of member States of the **European Union (EU)** are applied, the influence of Community law on international tax law must nowadays be considered. The sources of Community law are the **Treaty on European Union** of 7 February 1992 (**EU Treaty** or **Maastricht Treaty**) and the **Treaty Establishing the European Community** - formerly the European Economic Community - of 25 March 1957 (**EC Treaty** or **Treaty of Rome**) as amended by the Maastricht Treaty. Both Treaties and their accompanying documentation have come to be known as '**primary Community law**' as opposed to the rules derived from the treaties by the Community organs. The most significant aspect for international tax law are the **market freedoms**, which were established and guaranteed by the Treaty of Rome. These include:

- Freedom of **Transport of Goods**
- **Free Movement of Workers**
- Freedom of **Establishment** of enterprises
- Freedom of Movement of **Services** and
- Freedom of Movement of **Capital**

Equally important for the member States are the prohibitions against discrimination, stemming from the market freedoms, and the general prohibition arising out of Art. 6 (formerly Art. 7) of the Treaty of Rome which prevents the discrimination against nationals of member States based on their **nationality**. The *European Court of Justice (ECJ)* has played an important role in developing these rights of freedom and the prohibitions against discrimination and also in enforcing them. Recently, the Court has, among other things, decided a series of important cases concerning the taxation of income of EU citizens in other member States (for discussion of these, see the literature [supra, m.no. 136](#)).

[138] In addition to the 'primary Community Law', there is also 'secondary Community Law', consisting of directly applicable **regulations, directives, and decisions** (Art. 189 Treaty of Rome) enacted by the institutions of the EU. For international taxation, **directives** established under provisions of the Treaty of Rome are the most significant. Directives bind the member States to achieve certain legislative results - for example to adjust tax rules in a specified, common direction - but in principle the choice of form and method is left to the States to decide. Notwithstanding, if a member

State only partially implements a directive or otherwise impairs it, according to the decisions of the *ECJ*, **citizens** have directly applicable rights based on the directive as long as it is sufficiently 'clear and precise' and 'unconditional' (*ECJ*, Case 8/81 'Becker', 1982 ECR 53). Actions by the Council or Commission which **lack binding legal authority** include programmes such as the 'Guidelines on company taxation', published by the Commission in 1990, or the Working Document 'Towards a strategic programme for the internal market' from 1993 (regarding these issues, see *Albregtse, D., & Heithuis, E.*, EC Tax Rev. 7 (1994) and *Schonewille, P.*, EC Tax Rev. 56 (1994)). The **Recommendation**, a type of action chosen by the Commission for the first time in 1993, lacks binding legal authority too (Recommendation of 21 December 1993, on the taxation of certain items of income received by non-residents in a member State other than in which they are a resident, 94/79, OJ 39/22 (1994); regarding this Recommendation, see *Thömmes, O.*, Intertax 182 (1994); *Schonewille, P.*, EC Tax Rev. 63 (1994)). However, this Recommendation is intended to articulate **legal obligations** which in the view of the Commission arise from the Member States directly from the founding Treaties. Therefore, if the Recommendation is not observed, the Commission has threatened to introduce treaty violation proceedings. The 'Recommendation' is therefore intended by the Commission to be more than a Programme, although it is not a Directive which the Commission would not be authorized to enact. A Recommendation of the Commission that does not threaten sanctions is, e.g., the Commission Recommendation of 25 May 1994 concerning the taxation of small and medium sized enterprises, 1994 OJ (L 127).

2. Impact on double taxation treaties

- [139] If a law or regulation of a member State contradicts Community Law, the Community rule prevails. The domestic provision conflicting with Community Law is not considered to be null and void, rather it is **inapplicable** (*ECJ*, Case 6/64 'Costa & ENEL', 1964 ECR 1251; Case 106/77 'Simmenthal', 1978 ECR 629, affirmed by subsequent rulings). The relationships of the Community law to international treaties of the Member States, in contrast, are varied; some problems here, moreover, remain unsolved.
- [140] The relationship of international treaties to '**primary Community law**' is governed by Art. 234 of the Treaty of Rome, however only in part. The article covers agreements with **non-member States**; it differentiates between treaties which were already in force prior to the signing of the Treaty of Rome ('**old treaties**') - for States which have joined subsequently, Art. 234 governs correspondingly for treaties concluded prior to their admission - and later concluded '**new treaties**'. Old treaties with third states have remained effective under Art. 234, even if they contradicted EEC law. However, the member State bound through such treaty was (and is) obligated to eliminate the conflict through 'all suitable means'. Thus, it should initially attempt to negotiate with the treaty partner concerning the problem and, if necessary, it should terminate the treaty as far as this is permissible. This rule is equally applicable to States that either joined the EEC following its founding or may join in the future and have treaties which were concluded prior to their accession.
- [141] Article 234 is silent concerning **new treaties with third states**. The initial question is the extent to which the member States are authorized to conclude such treaties. With regard to tax treaties, it is recognized that EC law does not limit the jurisdiction of member States to conclude them (in detail: *Scherer, Th.*, Doppelbesteuerung, [supra](#) **no. 136, 56 ff.**). However, treaties may conflict with Community law in two potential ways: they may either bind the **member State** that signed the treaty to behaviour which is in violation of Community law, or they may authorize or oblige the **third state** to engage in behaviour which **in the territory of the Community** leads to a result that is contrary to Community law (for example, if, in the territory of a member State, they favour enterprises owned by residents of that member State while disregarding enterprises owned by residents of other member States: as is the case under Art. 28 DTC *Germany/USA*, which impairs the freedom of establishment as guaranteed under Art. 52 of the EC Treaty by discriminating against non-German residents). A member State may violate Community law by concluding such agreements; however, they are still valid and may rightly be applied by the third state as it, of course, is not bound by Community law (likewise *Hinneken, L.*, [supra](#) **no. 136**, at 162). The member State party to such a treaty is, as with old treaties which conflicted with EEC law, bound to clear up the collision (Art. 5 Treaty of Rome). It is further possible that the member State must

pay compensatory damages to a taxpayer harmed by the treaty-violating provision; however, the conditions that may lead to the imposition of this duty have not yet been made clear by the *ECJ* (*Hinneken, L., loc. cit.*).

- [142] Whether the same is true when a new treaty of a **member State** obliges it to act contrary to Community law is uncertain. Such treaties are also clearly valid under international law. It has been maintained, however, that the treaty rule in violation of Community law is **inapplicable** within the member State in the same way as are domestic laws which are incompatible with Community law (*Vedder, C., supra* [m.no. 136](#), at 8; *id.*, in Grabitz, E., & Hilf, M. (eds.), *Kommentar zum EWGVertrag* (loose-leaf), at [Art. 234, m.no. 5](#)). This view is not without its problems; it presupposes that Community law can claim primacy with respect to both domestic law and domestically applicable **international treaties**. Whether one can presume this, both generally and especially for those EU Member States whose constitutions provide that international treaty law takes precedence over domestic law (as in France and the Netherlands), must be assessed. It is possible, however, that the *ECJ* will support this view (*Heithuis, E.J.W., supra* [m.no. 136](#), at 1654).
- [143] If treaties **between member States** contravene Community law, Community law will unquestionably prevail (*ECJ* Case 10/61, 'Commission/Italy', 1962 ECR 1; Case 266/81, 'SIOT', 1983 E.C.R. 731; *Heithuis, E.J.W., supra* [m.no. 136](#), at 1652f.). This result arises out of Art. 234 of the EC Treaty for old treaties (*argumentum e contrario*), while it governs *a fortiori* for new treaties. Rules in such treaties which violate Community law are **not valid under international law**. This applies, for example, to treaties that discriminate against citizens of other EU member States in violation of Community law (see further, *infra* [Art. 24, m.nos. 5b ff.](#)). To the extent that double taxation conventions between EU member States differ substantively and thus lead to differing advantages and disadvantages for persons resident in the contracting States, it must be considered that such treaties are based on a negotiated give and take from case to case. The circumstances of EU citizens who are resident in different member States and to whom different DTCs are therefore applicable, are, in this regard, not 'equal'. It is therefore not discrimination if they are entitled to different DTC benefits under the provisions of the respective treaty. A claim to the application of a favourable DTC concluded with another member state can consequently not be derived from Community law (as in *Herzig & Dautzenberg*, 45 DB 2519 (1992); possibly also *Scherer, Th., Vorgaben, supra* [m.no. 136](#), at 957f.; *id.*, *Doppelbesteuerung, supra* [m.no. 136](#), at 113 ff.; in contrast to these authors' view, therefore in accordance with this commentary, are, *Thömmes, O., & Vedder, C., Diskussionsbeiträge, in: Lehner & Thömmes et al., supra* [m.no. 136](#), at 64).
- [144] From 'secondary Community law', **directives** are of particular significance for DTCs. They may influence treaty law in one of two ways (see *Lehner, M., Perspektiven, 24 ff.; id., Auswirkungen, 24 ff.; id., Beseitigung, 939ff.*); *viz.*, a directive may have either a **direct treaty impact** or an **indirect treaty impact**. Directives have a **direct treaty impact** when they oblige the member States to enact legislation that competes with DTC provisions, replaces them or neutralizes their effect (e.g., exempting certain income from taxation in the source State or providing for a tax credit). They have, in contrast, only **indirect treaty impact** if the directive aims at changing domestic law to which DTCs expressly or implicitly refer (e.g., the domestic rules on determination of profits as prerequisite for the allocation of profits under Art. 7 MC). Directives with indirect treaty impact may broadly influence and change treaty law, too. A **conflict** between directive and DTC may arise, however, only with directives which have a **direct** treaty impact.
- [145] Even directives which have a direct treaty impact will not necessarily result in a conflict, and indeed a conflict is not the rule. The provisions of a directive may be **treaty compatible** or **treaty incompatible**. They are treaty compatible if they are directed towards the enactment of member States' laws which complements the rules of applicable DTCs and which in certain cases may obviate the need for their application. However, they will permit the application of those DTCs where their legal consequences go beyond those provided for by the directive. The DTC and the implementing domestic law are then applicable side-by-side (**cumulativity**). Such cumulativity may be expressly prescribed. For example, the so-called '**Parent-Subsidiary Directive**' (Council Directive 90/435 of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member States, 1990 OJ (L 225) 1, 6) stipulates in Art. 7 (2) that the DTC rules on the taxation of dividends shall remain unaffected by the corresponding directive rules. Tax liability may be governed, then, by the provision which is **more favourable** to

the taxpayer (with regard to Art. 7 (2) : *Thömmes, O. & Betten, R.*, EC Corporate Tax Law, Comm. on [Art. 7, 6.7, m.no. 9](#) (loose-leaf service 1991ff.)). Since the Parent-Subsidiary Directive controls only relations among the EU member States, DTCs with third states remain unimpaired by the directive (*Heithuis, E.J.W.*, [supram.no. 136](#), at 1653; differing is *Hamaekers, H.*, [supram.no. 136](#), who thinks that the member States have lost their competence to conclude treaties with third states in the area of the Directive). Regarding an already older directive, No. 69/335 of July 17, 1969, OJ L 249/25, on indirect taxation of capital accumulation, the *Hoge Raad* confirmed the same view (Rolno. 28/603 BNB 1994/209: the *Netherlands'* DTC with *Japan*; see, too, [infra Art. 24, m.no. 165a](#)). In other cases the treaty compatibility of the provision of a directive may be established by way of **interpretation**. For example, definitions provided for in a directive do not exclude the application of differing definitions coming from a DTC. However, where DTCs refer to domestic law for certain definitions, treaty terms are now to be interpreted according to the provisions of the directive (*Lehner, M.*, *Perspektiven*, [supram.no. 136](#), at 27).

[146] In contrast, directives are **treaty incompatible** if they exclude the application of certain DTC provisions. The relation between treaty and directive, then, is one of **mutual exclusivity**. The **legal consequences** of such a conflict correspond to those found when treaty law contravenes primary Community law. Thus, treaties **between member States** become inoperative to the extent that they contradict the directive. Treaties **with third States**, in contrast, remain valid (sceptical: *Petersmann, E.-U.*, in H. von der Groeben, J. Thiesing, C.-D. Ehlermann (eds.), *Kommentar zum EWG-Vertrag*, Vol. 4, on [Art. 234 m.no. 6](#) (4th ed. 1991)). Moreover, when those treaties were concluded prior to the issuance of the directive, they remain domestically applicable. In contrast, it is questionable whether treaties with third States finalized after the publication of the directive may remain domestically applicable (as in [supram.no. 142](#)). In both cases, though, the concerned member State is obliged to attempt to modify the treaty in accordance with the directive (*Scherer, Th.*, *Vorgaben*, [supram.no. 136](#), at 959; *id.*, *Doppelbesteuerung*, [supram.no. 136](#), at 120f.).