

The David R. Tillinghast Lecture*

Are Tax Treaties Necessary?

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I. INTRODUCTION

It is a great honor to be asked to give the second David R. Tillinghast Lecture on International Taxation. I have been interested in tax treaties for something like 25 years. Most of this time has been spent with my head in the detail, discussing things such as whether a state has to exempt or give credit for tax on income that it thinks the source state should not have taxed or should have taxed under a different treaty article. During that time, I have been greatly influenced by people in the United States. I should particularly like to pay tribute to Sidney Roberts, who first made me interested in treaties by asking those apparently simple but unanswerable questions, and, international consultant to the very stimulating ALI project on treaties.¹ Some of you have seen me before at those meetings in a jet-lagged state, coming over on two-day visits, and here I am again in the same state.

II. GLOBALIZATION

Taxpayers have become global; tax authorities have not. They are necessarily national, or at best, they work bilaterally. Is it not obvious that tax authorities are fighting a losing battle?

I am sure that those of you who teach at NYU have experienced the same difficulty as I have in trying to explain to students why it was necessary to have some 1,400 separate bilateral tax treaties in order to make the international tax system work, particularly so when all other international relations are conducted differently. Why is tax different from other international trade matters? International trade negotiators think globally. One cannot imagine indirect tax governed by bilateral treaties.

Tax treaties are a very considerable success story for the OECD and its predecessors, the League of Nations, and the OEEC. What other

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¹ ALI, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties (1992).

international organizations have achieved such success in a field where states closely guard their sovereignty? One can pick up any modern tax treaty and immediately find one's way around, often even down to the article number. Obviously, there are some variations, but the major part is the same as the OECD Model Treaty.²

Now that the influence of the United Nations in this area has declined since its excellent work, to which Stanley Surrey contributed so much, of preparing a rival model treaty for developing countries,³ the OECD has taken its place and is becoming the world body overseeing tax treaties. There seems little need for a separate model for developing countries. All that is needed is an acceptance by OECD members of the developing countries' need for more source tax, which certainly seems to be accepted in the United Kingdom and I am sure elsewhere. (I will resist the temptation to mention tax sparing). This development is entirely logical. Most of the OECD Model Treaty is used by everyone and so the OECD should ensure that it is interpreted in the same way by everybody, regardless of whether they are member countries of the OECD. I was interested to hear that the OECD is working on publishing nonmember countries' observations and reservations, which will help to demonstrate its worldwide role in this area.⁴

The success of tax treaties can be measured by their number. Last year, we in the United Kingdom held a party at the Treasury to celebrate being the first country to have 100 treaties in force. We entered into the first 50 between 1945 (our first comprehensive treaty was the 1945 treaty with the United States⁵) and 1951; the second 50 took a

² OECD, Model Income Tax Convention on Income and Capital, July 23, 1992, 1 Tax Treaties (CCH) ¶ 191 [hereinafter OECD Model Treaty].

³ United Nations, Model Double Taxation Convention Between Developed and Developing Countries, Jan. 1, 1980, 1 Tax Treaties (CCH) ¶ 206 [hereinafter U.N. Model Treaty].

⁴ These have been publicized in 2 OECD, Model Tax Convention on Income and Capital (Nov. 1997).

⁵ Income Tax Treaty, Apr. 16, 1945, U.K.-U.S., 4 Tax Treaties (CCH) ¶ 13,001 (expired). In the interests of historical accuracy, I should mention that this statement excludes the 1926 agreement with Ireland, Income Tax Agreement, Apr. 14, 1926, Ir.-U.K., 95 TNI 241-35, Dec. 15, 1995, available in LEXIS, Fedtax Library, TNI File (providing for tax in the residence state only), a number of agreements relating only to agency in the 1930's (which are the origin of the reference in the Model Treaty to an agent having an authority to conclude contracts), see, e.g., Albert A. Ehrenzweig & F.E. Koch, *Income Tax Treaties* 9-10 (1949) (stating that § 17 of the Finance Act of 1930 provided reciprocal exemption for agency profits, and that agreements were concluded with Argentina, Canada, Finland, France, Germany, Greece, Netherlands, Norway, South Africa, Spain, Sweden, and Switzerland), and a number of treaties relating to shipping and air transport from 1923, see, e.g., *id.* (stating that § 18 of the Finance Act of 1923 permitted reciprocal exemption from tax on shipping profits, which was extended for air transport by § 9 of the Finance Act of 1931, and such agreements were concluded with the United States, Denmark, France, Germany, Japan, the Netherlands, Norway, and Sweden), and a death duties treaty with the

little longer. I think you have a little way to go to catch up. This increase in the number of treaties is a general trend. In 1939, there were 20 treaties between OECD members, 85 at the time of the 1963 Draft,⁶ 179 at the time of the 1977 Model Treaty⁷ and 475 (out of a possible 552) in 1995.⁸

The disadvantage of the tax treaty route is that it is self-perpetuating. Treaties are a one-way street; they lead only to more treaties. The reason why treaties do not lead to useful harmonization of tax laws is what normally is referred to as sovereignty, but is really the need to preserve one's negotiating position. The more outrageous the provisions of internal law, the better the starting position for negotiating treaties. One state will introduce a crazy tax system with the knowledge that other countries will come running to its door asking for a treaty in familiar form, which it will willingly give the other state, subject, of course, to some concessions on the part of the other state, which it does not mind giving because its system was designed to allow for this. The ideal tax system is to have plenty of high withholding taxes on nonresidents to make them want treaties, but a good system of relief from double taxation so that the lack of treaties is not too much of a problem for one's own residents.⁹ I think we can recognize something of that in both our countries' tax systems. So long as states are prepared to sign up to the OECD Model Treaty with some fairly

Swiss Canton of Vaud in 1872, *Legacy Duties Declaration*, Aug. 27, 1872, Sw.-U.K., 62 *British and Foreign State Papers* 20 (1877) (abrogated by *Exchange of Notes Concerning Death Duties in the Canton of Vaud*, Sw.-U.K., Dec. 24, 1957, reprinted in Walter H. Diamond & Dorothy B. Diamond, 6 *International Tax Treaties of All Nations* 439 (1976) [hereinafter *International Tax Treaties*].

⁶ OECD, *Draft Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital*, June 30, 1963, 1 *International Tax Treaties*, note 5, at 7 [hereinafter 1963 OECD Model Treaty].

⁷ OECD, *Model for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital*, Apr. 11, 1977, 1 *Tax Treaties (CCH)* ¶ 201 [hereinafter 1977 OECD Model Treaty].

⁸ OECD Model Treaty, note 2, app. 1 (Sept. 1995).

⁹ In many ways, the estate tax, which we call inheritance tax, is the ideal. See, e.g., *Inheritance Tax Act 1984* §§ 6, 48, 155 (U.K.) [hereinafter 1984 IHTA] (excluding from taxation property situated outside the United Kingdom if the person beneficially entitled to it is domiciled outside the United Kingdom), § 267 (defining beneficiaries who are "deemed domiciled" in the United Kingdom for inheritance tax purposes), § 159 (permitting credit for foreign tax of a similar nature), § 158 (alternative relief under a double taxation agreement between United Kingdom and another country). Virtually everything is taxed on a situs basis, but the double taxation relief even takes into account taxes in the other state not based on situs, for example, (which would be relevant if we did not have a treaty) the U.S. tax on worldwide assets on the basis of citizenship, which I think is unique. See IRC § 2001 (tax imposed on the transfer of the taxable estate of every decedent who is a U.S. citizen), § 2031 (gross estate includes value of all property of decedent, wherever situated). But see IRC § 2014 (credit given against federal estate tax for death taxes actually paid to any foreign country with respect to property included in decedent's gross estate but situated in the foreign country).

minor variations, they can have any provisions they like in their internal law affecting international transactions. Nobody can complain; as good OECD members, both states have complied with the rules of the club by signing up to the Model Treaty form. There is no incentive for anyone to have a more sensible internal law that, in the long term, might reduce the need for treaties. Consequently, nobody ever will.

As an example of the type of provision to which I am referring, which I assure you is entirely hypothetical, a state might have a 30% withholding tax on dividends. This certainly leads down a path to other states wanting treaties, but it does not stop there. Treaties lead inexorably to treaty shopping, and that leads to limitation of benefit articles in ever more complex forms. I am not alone in wondering if the cure is not to tackle the withholding tax in the first place.¹⁰

The success of tax treaties brings problems with it. The real problem in having numerous treaties is the same as what investors call lock-in: One cannot change investments without paying capital gains tax and so individuals are encouraged to hold on until death when capital gains are wiped out, even though inheritance tax, as we misleadingly call our estate tax, may not be payable because of our equivalent of your marital deduction.¹¹ I imagine that investors behave in the same way in the United States. In the international tax field, lock-in affects both treaties and internal law. Treaties cannot be changed because there are so many of them and so the OECD tends to rewrite the Commentary instead of the Model Treaty, leading to problems that I consider later. And treaties inhibit changes in internal law, which would have no effect in cases where treaties exist, that is to say, in most of the cases that matter. This leads to either the changes not happening or to treaty override.

The road to more and more treaties might not matter if they were the perfect answer to globalization of taxpayers, but I doubt if any of you think that they are. Ian Spence, the Director of the International Division of the U.K. Inland Revenue has described tax treaties as "a bolt-on exercise in damage limitation."¹² He goes on to add, and I agree with him, that bolt-ons sometimes work. He concludes "[t]ax, I would suggest, is not a major disruptive factor in world trade and investment. And distortions have not yet reached the unacceptable stage, but they might."¹³ The OECD has made some calculations showing the distortions caused by tax, and the degree to which this is

¹⁰ David R. Tillinghast, *Tax Treaty Issues*, 50 U. Miami L. Rev. 455, 459 (1996).

¹¹ 1984 IHTA, note 9, § 18 (exempting transfers between spouses); IRC § 2056 (reducing gross estate by value of property passing to surviving spouse).

¹² Ian Spence, *Globalization of Transnational Business: the Challenge for International Tax Policy*, 25 Intertax 143, 144 (1997).

¹³ *Id.*

cured by treaties on various assumptions.¹⁴ The following table extracts the information for our two countries.¹⁵

TABLE 1
THE EFFECTS ON THE OVERALL AVERAGE REQUIRED RETURN
OF BILATERAL TAX TREATIES

Country	Domestic	<i>Residence</i> (Investment from named country into other countries)			<i>Source</i> (Investment from other countries into named country)		
		<i>With treaties</i>	<i>No treaties</i>	<i>% Difference</i>	<i>With treaties</i>	<i>No treaties</i>	<i>% Difference</i>
UK	5.9	6.7	8.2	1.5	7.0	9.0	2.0
US	5.8	7.1	8.2	1.1	7.5	10.7	3.2
OECD Average	5.9	7.5	9.7	2.2	7.5	9.7	2.2

The table shows the required rate of return on an investment that gives a return of 5% to a domestic tax-exempt taxpayer. Capital export neutrality would exist if the return under the residence heading were the same as the domestic column; capital import neutrality would exist if the return under the source heading were the same as the domestic column. As one would expect for two tax-credit countries, and in light of my suggested ideal tax system, treaties make less difference to domestic taxpayers investing abroad and are of more benefit to residents of other countries investing into the country. The United Kingdom and the United States are both well below the average difference as residence states, although the average is distorted by Norway, which requires a 23.6% return in the absence of treaties because it gives only a deduction for foreign tax.¹⁶ As source countries, the United Kingdom fares better than the United States, presumably because of your high rate of withholding tax in the absence of a treaty.¹⁷ My amateurish interpretation of the table is that for our two countries, treaties remove about one-half the distortion for one's own residents investing abroad, and two-thirds of it for other states' residents investing in one's country. This is good to know but hardly perfection. Of course, one cannot expect perfection, partly

¹⁴ OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* 143 n.1 (1991). The assumptions are (1) a subsidiary financed one-third by loans from the parent, one-third by new equity from the parent, and one-third retentions by the subsidiary, (2) the parent raises finance by a weighted average of retentions, new equity, and debt, (3) investment in a weighted average of assets, (4) inflation of 4.5% everywhere, and (5) no personal taxes.

¹⁵ *Id.* at 143.

¹⁶ *Id.*

¹⁷ *Id.*; see IRC § 1441.

because of problems caused by higher taxes in the other country, but I have a suspicion that quite a lot of the remaining distortion is caused by the existence of withholding taxes that are still permitted by treaties, although at a reduced rate.

A. Alternatives to Tax Treaties

If treaties are not the perfect answer, what are the alternatives? Would tax authorities be more global if there were multilateral treaties? I looked at the Nordic treaty and could not detect any difference between it and a series of bilateral treaties. There are, for example, separate double taxation relief provisions applying to Denmark, the Faroe Islands, Finland, Iceland, Norway, and Sweden, followed by some common provisions.¹⁸ There is an extremely lengthy attached protocol dealing with separate bilateral problems such as employment concerned with the erection of fences for reindeer on the Norwegian-Swedish frontier.¹⁹ I hear that the Austrians are proposing a multilateral tax treaty for the EU; I wish them luck but with the present state of diversity of tax systems, I am afraid the project is doomed to failure. But are we really all that far away from having a multilateral treaty today? If the Nordic treaty can be regarded as a series of bilateral ones sewn together, can one not equally regard the OECD Model Treaty as a template for a multilateral web of treaties? Indeed, there seems no obvious advantage in having multilateral tax treaties. What countries really do is to sign up to variations on the Model Treaty. Practitioners would save a lot of time if treaties were presented as variations to the Model Treaty; we would not need to read the rest to see whether it has been changed.

There have been attempts at multilateral treaties dealing with administrative matters, such as the OECD and Council of Europe Convention on Mutual Administrative Assistance in Tax Matters.²⁰ They have not been particularly successful in persuading countries to adopt it. This does not mean that there is anything wrong with the approach. Its main problem is that it tried to go too far too quickly. Expecting countries to collect each other's taxes is fine when there is some similarity between them, as is the case of VAT in Europe where we do collect other European states' VATs, but it is a large step when

¹⁸ Convention Between the Nordic Countries for the Avoidance of Double Taxation With Respect to Taxes on Income and on Capital, Sept. 23, 1996, Den.-Faroe Is.-Fin.-Ice.-Nor.-Swed., art. 2, ¶¶ 3, 4, 98 TNI 9-25, Jan. 14, 1998, available in LEXIS, Fedtax Library, WTD File [hereinafter Nordic Treaty].

¹⁹ Id. at Protocol, art. I, ¶ 1 (supplementing articles 7 and 15).

²⁰ Council of Europe-OECD, Convention on Mutual Administrative Assistance in Tax Matters, Jan. 25, 1988, 1 Tax Treaties (CCH) ¶ 215.

there has been no harmonization. Although not a multilateral treaty, the OECD Transfer Pricing Guidelines²¹ are probably the most significant recent development in harmonization not only of how transfer pricing operates in practice but also of one's internal law on the subject, although I believe you may have different views.

One might expect that trade treaties contained tax provisions. The problem is that international trade negotiators do not understand direct tax. Either they put their heads in the sand, as in the EC Treaty,²² or more normally these days, they opt out of tax, as in NAFTA²³ and GATS.²⁴ Tax treaties are referred to in GATS in an article headed General Exceptions:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:

. . . .

(e) inconsistent with Article II [most-favoured-nation treatment], provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.²⁵

The thinking is presumably that trade treaty negotiators regard tax as an arcane mystery. They know that there are lots of tax treaties around that apparently work, so why not leave tax alone and get on with the things they understand?²⁶ Will the multilateral agreement on

²¹ OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, reprinted in 9 Tax Notes Int'l 155 (July 18, 1994).

²² Treaty Establishing the European Community, Feb. 7, 1992, 31 I.L.M. 247 [hereinafter EC Treaty].

²³ North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 289; 32 I.L.M. 605 [hereinafter NAFTA].

²⁴ GATT-Multilateral Trade Negotiations (The Uruguay Round): General Agreement on Trade Services, Dec. 15, 1993, 33 I.L.M. 44 [hereinafter GATS].

²⁵ Id. art. XIV, ¶ (e), 33 I.L.M. 44, 57-58. Paragraph (d) of the same article also contains an exception to the requirement of national treatment for differences aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers, with a footnote setting out the type of measures to which this refers, such as different taxation of residents and nonresidents. Id. art. XIV, ¶ (d), n.6.

²⁶ See Jeffrey Owens, Emerging Issues in Taxing Business in a Global Economy, in OECD Proceedings, Taxing International Business, Emerging Trends in APEC and OECD Economies 25, 31-34 (Richard Vann ed., 1997).

investment (MAI), which the OECD is negotiating at the moment,²⁷ be any different?

B. How Should Trade Treaties Deal With Tax?

One cannot really blame trade treaty negotiators for opting out of direct tax. I would find it extremely difficult to answer my question of how trade treaties should deal with tax. One might have expected that the EU would have solved this problem, but this is far from the case. One point is clear. One cannot depend on simple solutions such as a general nondiscrimination provision. Let me give you an idea of what we are suffering in Europe at the moment. Apart from a passing reference to tax treaties,²⁸ the Treaty of Rome has no provisions about direct tax except for a nondiscrimination article, or rather a series of nondiscrimination articles dealing with different freedoms, such as the freedom to establish a business in another member state. Any EU direct tax legislation has to be made under an article providing for the establishment or functioning of the common market, rather than a provision dealing specifically with direct taxation.²⁹

As we know from the OECD Model Treaty, what tax people regard as an acceptable nondiscrimination article and what trade treaties include are rather different. The Model Treaty's nondiscrimination provision contains a general provision about nationality discrimination that has little effect in most countries since nationality is not a criterion for taxation.³⁰ Of course, the United States is an exception and you have to be careful about what this provision contains, hence your observation that your nonresident citizens are not in the same circumstances as other nonresidents.³¹ The rest of the article in the OECD Model Treaty contains some limited provisions about nondiscrimination in relation to taxing business profits.³² A recent EU case³³ on the

²⁷ See OECD Policy Brief, MAI, The Multilateral Agreement on Investment (visited Mar. 7, 1999) <http://www.oecd.org/publications/Pol_brief/9702_Pol.html>.

²⁸ Treaty Establishing the European Economic Community, Mar. 25, 1957, art. 220, 198 U.N.T.S. 11 [hereinafter Treaty of Rome].

²⁹ Id. art. 100.

³⁰ OECD Model Treaty, note 2, art. 24, 1 Tax Treaties (CCH) ¶ 191. That article reads as follows:

Nationals of a Contracting State shall not be subject in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other state in the same circumstances, in particular with respect to residence, are or may be subjected.

³¹ OECD, Model Tax Convention on Income and Capital, 1995, art. 24, Commentary ¶ 62 [hereinafter OECD Commentary].

³² OECD Model Treaty, note 2, art. 24(3), 1 Tax Treaties (CCH) ¶ 191.

³³ Case C-107/94, P.H. Asscher v. Staatssecretaris van Financiën, E.C.R. I-3089, I-3054 to I-3096 (1996); 1996 ECJ CELEX LEXIS 4657, 4668.

higher rate of tax charged by the Netherlands on nonresidents demonstrates how little is covered by tax treaties. The precise question in the case was whether it was discriminatory for the first band of income to be taxed by the Netherlands at the rate of 13% for residents³⁴ (and nonresidents deriving 90% of their income from the Netherlands) and 25% for nonresidents.³⁵ The justification claimed for this difference by the Netherlands was that only part of the taxpayer's total income is taken into account in the case of a nonresident and so their circumstances are different and accordingly, there is no discrimination.³⁶ Clearly, the tax treaty did not prevent this, although it would have done so if a permanent establishment had been involved.³⁷

The Treaty of Rome, on the other hand, has virtually unlimited nationality nondiscrimination provisions³⁸ that have been widely interpreted by the European Court of Justice to include covert discrimination, such as discrimination against nonresidents, on the ground that most nonresidents are non-nationals and so effectively the discrimination against nonresidents is discrimination against non-nationals.³⁹ The difference in tax rates in the Netherlands was discriminatory under the Treaty of Rome on the basis that there was a progressive tax system in the residence state and so one could validly compare the position of a resident and a nonresident,⁴⁰ an argument I find rather unconvincing because it surely would have been just as discriminatory if the residence state did not have a progressive tax system.⁴¹

The other type of case that has arisen concerns whether it is discriminatory for the state in which an individual is working not to give personal allowances or pension deductions to a nonresident. The European Court, to the great relief of tax authorities, has come out firmly in saying that a resident and a nonresident are not in the same circumstances and so there is no discrimination in treating them differ-

³⁴ In addition, 22.1% national insurance contributions were payable. *Id.* at I-3092, I-3094.

³⁵ *Id.*

³⁶ *Id.* at I-3126.

³⁷ In the case of a permanent establishment, the Commentary points out that there is nothing to prevent the permanent establishment state from determining the rate of tax on the profits of the permanent establishment by taking into account the profits of the whole company. OECD Commentary, note 31, art. 24, ¶ 37.

³⁸ Treaty of Rome, note 28, art. 6.

³⁹ Case C-175/88, *Biehl v. Administration des Contributions*, 1990 E.C.R. I-1779, I-1793 (1990); 1990 ECJ CELEX LEXIS 2566.

⁴⁰ Case C-108/94, *P.H. Asscher v. Staatssecretarities van. Financiën*, 1996 E.C.R. I-3089, I-3124 to I-3125; 1996 ECJ CELEX LEXIS 4657.

⁴¹ See John Avery Jones, *Further Thoughts on Non-discrimination in Europe Following Asscher*, 1997 Brit. Tax Rev. 75.

ently.⁴² At the edges, however, the court recognized that residents and nonresidents may be in the same position. An example is when all or nearly all of a person's income is earned in the state in which he is not a resident, the typical case of the frontier worker.⁴³ The court also has found it to be discriminatory for the work state not to give personal allowances in a case where the residence state has exempted the income earned in the other state.⁴⁴ This is understandable. If the person does not receive any allowances in the work state because he is a nonresident, or in the residence state because he does not pay any tax, he is clearly worse off than a resident of the work state. The difficulty I have with the decision is the effect it has in a tax-credit country where the person also pays tax in his residence state and receives allowances there. If the work state is obliged to give allowances because of this decision, all that happens is that there is less tax in the source state to credit and hence more tax in the residence state; it is the familiar tax sparing point. If this is right, the decision, far from harmonizing the tax system, increases the discrepancy between tax credit states and exemption states.

So far, with one exception, these cases have concerned individuals; the problem will be more serious when the court considers companies. The exception concerns the right of a French branch of a nonresident insurance company to receive a French shareholder's tax credit, the *avoir fiscal*, on dividends from French companies.⁴⁵ The European Court held that this had to be paid to the branch as it would be to a French subsidiary since, in this respect, there was no difference between the taxation of a branch or a subsidiary in France.⁴⁶ The nonresident EU company had exercised its right to establish itself in France as a branch rather than a subsidiary and should not be discriminated against because it chose a branch.⁴⁷

There is a case pending on whether the ability of U.K. resident companies to pay intergroup dividends without paying advance corporation tax (ACT), extends to dividends paid to other EU parent companies.⁴⁸ The argument is presumably the same as in the French case but applied to the opposite circumstance; that is, there would have been no ACT if the parent company had established a branch in

⁴² Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225, I-236; 1995 ECJ CELEX LEXIS 4031.

⁴³ *Id.*, at I-240, ¶ 68.

⁴⁴ *Asscher*, 1996 E.C.R. I-3089, at I-3126, 1996 ECJ CELEX LEXIS 4657, ¶ 34.

⁴⁵ Case 270/83, *EC Commission v. France*, 1986 E.C.R. 273, 1986 ECJ CELEX LEXIS 2196.

⁴⁶ *Id.* at 305.

⁴⁷ *Id.*

⁴⁸ *Hoechst v. Commission* (pending).

the United Kingdom, so that it is discriminated against if it has to pay ACT because it chose to establish a subsidiary. One's instinct is that the difference is covered by the European Court's acceptance in the earlier cases that residents and nonresidents are generally not in the same situation. Since, however, a U.K. resident parent company is not liable to tax on dividends from U.K. resident subsidiaries, a non-resident parent company is in a similar position. That the European Court could strike down a fundamental part of the U.K. corporate tax system is clearly unsatisfactory and demonstrates that direct tax cannot be left to vague provisions about discrimination in trade treaties.

The conclusion is that while trade treaty negotiators continue to defer to tax treaties, tax authorities are not likely to make any progress away from more and more tax treaties and towards globalization. Surely the next logical step is for the OECD, having become the representative organization on tax for all states, not just its members, to take charge of international tax on a world basis in a way that would lead to treaties becoming obsolete. That would be building upon, not destroying, its (and its predecessors') excellent work of the last 70 years in harmonizing tax treaties because, without them, no progress would have been possible. I wonder whether the Multilateral Agreement on Investment will be the first step on that road.

So will tax authorities ever learn to become global? If I were a tax authority, I would be giving serious thought to a solution not based on bilateral treaties. But since I am not representing a tax authority, that is the end of my grand thoughts. I now return to the world as it is, the bilateral world of tax treaties, and look at a few ways in which they might be improved, on the basis that they will be with us for some time.

III. CURRENT ISSUES FOR TAX TREATIES

A. Overview

I should like to look at a few specific topics, beginning with categorization of income. Treaties are a set of rules for different types of income. As all tax lawyers know, the problems are caused by dividing lines. It has been clear for some time that the world does not fit neatly into self-contained compartments created by the OECD. Charlie Kingson, in this lecture last year, argued that the treaty had not kept up with technology and could not cope now that what mattered was not physical but intangible property.⁴⁹ Is there any hope of improvement?

⁴⁹ Charles I. Kingson, *Taxing the Future*, 51 *Tax L. Rev.* 641 (1997) (David R. Tillinghast Lecture).

I first turn to qualification conflicts. Leading on from the first topic, if one has different rules for different categories of income, what is the effect of each state thinking that the other state, by its interpretation, should have acted differently? Is it really the case that each state applies its own meaning of terms with the result that the residence state can refuse to give relief if it interprets a term differently from the source state?

My next topic is the interpretation of the OECD Model Treaty. The OECD Commentary is much more than a mere commentary. One cannot imagine the Model Treaty without it. Where would we be with just the vague wording of the Model Treaty? Its influence in harmonizing the interpretation of treaties is enormous. But does it have the legal status it deserves? In particular, what is the status of changes to the Commentaries made after the treaty concerned?

Finally, I examine how well the treaties fit together. In the early days, when treaties were being designed, it was reasonable to look at treaties as individual bargains between two countries, and not to look at the relationships between any other countries. This is no longer the case, and generally all countries with which I shall be concerned will have treaties between them, and so the way they fit together is significant. A significant question, however, is whether the Model Treaty fits together as well as it should when more than two countries are involved. An examination shows that it was designed purely on a bilateral basis.

B. Categorization of Income

To see why treaties contain separate rules for different types of income, it is necessary to start at the very beginning of tax treaties. The sad thing is that history shows that in this respect, they are built on shaky foundations. The League of Nations' four wise men, who included Edwin Robert Anderson Seligman from the United States and Sir Josiah Stamp from the United Kingdom,⁵⁰ concluded in 1923 that one could not solve the double taxation problems of an income tax by means of different rules for different types of income.⁵¹ At the time they were looking at the problem, most of the taxes with which they were dealing in Europe were not income taxes as we now know them, but *impôt reals*, an untranslatable expression for a series of separate taxes imposed on different types of income on a source basis, such as a

⁵⁰ The other two were G.W.J. Bruins (Netherlands) and Luigi Einaudi (Italy).

⁵¹ Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, League of Nations Doc. E.F.S.73.F.19 (1923) [hereinafter 1923 Report], reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4049 (1962) [hereinafter Legislative History].

tax on land, a tax on business profits and the like, rather like the tax system in Hong Kong today, assuming that this has not changed under Chinese rule. When the League of Nations Technical Experts were deliberating in 1925, the most recent treaty was Italy-Czechoslovakia (1924), which classified taxes into income from immovable property, income from mortgages, income from securities, income from savings bank deposits, income from other movable capital, earned income, income from industry or business, life annuities, and other income.⁵² All of these related to *impôt reals*; income tax was not introduced into Italy until 1925.⁵³ The Technical Experts recognised an extended list of *impôt reals*: immovable property, industrial and commercial establishments (including a branch or agency or permanent establishment, shipping enterprises, railway companies, trans-Atlantic cables, aerial navigation companies and electrical power undertakings, insurance companies, and banks), mortgages, directors' fees, earned income, transferable securities, and various credits and annuities.⁵⁴ One can put the article numbers of the OECD Model Treaty on most of these today. On top of these separate source-based taxes, there were just beginning to be residence-based income taxes. There was some source taxation under these income taxes; this applied to income from immovable property, mortgages, an unincorporated industry or business, and earned income.⁵⁵ In order to fit the two together, the only answer was that the income tax exempted anything covered in the other country by the source-based tax, leaving the income tax to apply in a residual category.

When the Technical Experts prepared their first model in 1927, it was divided into two parts, relating first to impersonal taxes (*impôts reals*), and second, to personal taxes (or income tax as we now know it). Under the first heading, states were allowed to tax the following, all levied on a source basis: income from immovable property (which included income from mortgages), income from public funds, bonds (although the source taxation was to be refunded on proof of residence in the other state), income from shares (taxable where the real center of management of the company was situated), industrial, commercial, or agricultural undertakings, and trades or professions (taxable where a permanent establishment was situated; the exclusion for independent agents was already there), although maritime concerns were taxable only in the state of the real center of management, man-

⁵² Report Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. F.212 (1925), reprinted in 4 Legislative History, note 51, at 4072-73 [hereinafter Technical Experts Report].

⁵³ Id. at 4073.

⁵⁴ Id. at 4091-92.

⁵⁵ Id. at 4073.

agers' and directors' fees (taxable in the state of the real center of management of the company), salaries and wages (where earned, or for government employees the paying state), and pensions.⁵⁶ Annuities and all other income was taxable only in the residence state.⁵⁷ Pausing there, we already have the basis of articles 6, 7, 8, 10, 11, 14, 15, 16, 18, 19, and 21 of the current OECD Model Treaty, the only real differences being that for interest, the tax was refundable and the rule for pensions is now the reverse⁵⁸ (although the Nordic countries are being quite successful in changing this because their residents tend to retire to warmer countries). And all that was before the draft dealt with what we now call income taxes.

The second part of the 1927 Model Treaty dealt with personal (or income) taxes, which were charged in the state of permanent home, an expression still to be found in the Model Treaty.⁵⁹ A later article dealt with dual residents by dividing the tax in proportion to the length of stay in each country. If the residence state did not have impersonal taxes, it gave credit for both the source impersonal tax and the personal tax on income from immovable property and industrial or commercial or agricultural undertakings, limited to a percentage to be negotiated of the total tax⁶⁰ (this was the method then used by the United Kingdom). If the residence state had impersonal taxes, it gave no credit for the other state's impersonal taxes against its income tax since this was merely a supplement to its impersonal taxes.⁶¹

The 1928 League of Nations report put forward three models: (1) draft 1a, which was basically the same as the 1927 draft, except that there was now no refund of source tax on interest (article 11 of the Model Treaty was thus fully in place); (2) draft 1b (the U.S. and U.K. position), which made no distinction between personal and impersonal taxes but which did not have any source taxation of investment income, and which avoided double taxation by the credit method; and (3) draft 1c (what happened in practice), which also made no distinction between types of taxes and had a scope similar to draft 1a, but with residence-based tax permitted on investment income, although with a suggestion for source state reduction in the rate of tax.⁶² Credit or exemption applied to tax on movable capital, and exemption neces-

⁵⁶ Id. at 4091-92.

⁵⁷ Id. at 4092.

⁵⁸ OECD Model Treaty, note 2, art. 18, 1 Tax Treaties (CCH) ¶ 191.

⁵⁹ Id. art. 4.

⁶⁰ Technical Experts Report, note 52, at 4092-93.

⁶¹ Id. at 4092.

⁶² Report Presented by the Gen. Meeting of Gov't Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.562.M.178, reprinted in 4 Legislative History, note 51, at 4161-75.

sarily applied to everything else because they were essentially source-based impersonal taxes. Thus, the drafts moved from treaties catering to two types of taxes, with a lot of source taxation, to treaties that made no distinction between types of taxes and that also had a lot of source taxation. Obviously, there have been a lot of refinements since then but the basic pattern has not changed. Source taxation today is therefore the direct successor of separate source-based taxes on different types of income. Indeed, with an exemption system, there is little difference between an income tax and those separate source taxes; the charge on domestic income may be more comprehensive under an income tax but foreign income basically is taxed only on a source basis, just as it was for *impôts réels*, except for investment income where the taxes are shared.

Returning to the group of four in 1923, they had a separate section of their report for “the income tax proper in its developed form, as found in Great Britain, the United States and the German Empire,” which were the only real income taxes at the time.⁶³ Interestingly, that section came after the one on death duties and property taxes, which shows the relative lack of importance of income taxes at the time. They added that “[t]he discussion would also apply to that part of the French income tax known as the complementary tax, or *impôt global*, as well as to the similar Italian tax contemplated by the Law of 1919, the enforcement of which has recently been postponed.”⁶⁴ The Report is interesting in appreciating the impossibility of having rules depend on the type of income under an income tax. The example they gave was to compare the receipt of rent from a farm in the other state with farming profits derived from the same farm:

Is the income derived from rent or from profits, or from a combination of these with possible losses in other directions, or to what is it due? . . . Again, a legal entity in the form of a company is interposed between the resident in country A and the farm in country B. The rent or produce of the farm is only one of the items of income of this legal entity. This company receives a real or constructive rent, it mixes this rent with losses from other sources, and as a result it pays a very small sum in the shape of dividends to the resident in country A. Has that resident received, or has he not, the rent of the farm?

It will be seen that simplicity only exists in a minority of cases involving income tax and that we soon get into the re-

⁶³ 1923 Report, note 51, at 4049-55.

⁶⁴ *Id.* at 4049.

gion of impracticability if we attempt to apply method 4 [which they called the method of classification and assignment of source, that is, essentially what was then, and still is, contained in treaties] with precision.⁶⁵

That perceptive comment was written in 1923. Their preference was for residence-only taxation under an income tax: “[T]he reciprocal exemption of the non-resident . . . is the most desirable practical method of avoiding the evils of double taxation and should be adopted wherever countries feel in a position to do so.”⁶⁶ As to source taxation on the basis of different rules for different sources under an income tax, they concluded: “[W]e hold out no hopes of this proving to be a smooth and practicable arrangement.”⁶⁷ As we all know, their advice was ignored, and treaty practice went on as before, following the European tradition that had evolved under *impôt reals*, before there were any income taxes. The United States and the United Kingdom eventually were forced to follow the pattern or be left out.

The problem of residence-only taxation is that not all flows of income between countries are equal. The United Kingdom may have preferred this method out of self-interest. The four wise men gave some consideration to intergovernment settlements to compensate for this and the idea is still a live issue in Europe for VAT if we move from a destination-basis to an origin-basis VAT because governments will have to give credit for taxes paid to other states. The four wise men also looked to the long term when differences between income flows became less important as countries developed, “so that we may look forward to an ultimate development of national ideas on uniform lines toward method 2 [no source taxation], if not as a more logical and theoretically defensible economic view of the principles of income taxation, at least as the most practicable solution of the difficulties of double taxation.”⁶⁸ The revival of residence-only taxation of dividends from subsidiary to parent companies has been achieved in the EU by overriding the source taxation of such dividends permitted by tax treaties.⁶⁹ It is possible, though less likely, that intercompany interest and royalties may follow. Between countries in a similar state of development, we may be beginning to see at last a move away from source taxation.

⁶⁵ Id.

⁶⁶ Id. at 4055.

⁶⁷ Id.

⁶⁸ Id.

⁶⁹ See, e.g., Stanley C. Ruchelman, Ian D. Morgan, Harry A. Shannon, David Glynn & Hans Decleir, *European Approaches to Hybrid Entities and Financing Structures: An Introduction*, 14 *Tax Notes Int'l* 1487 (May 5, 1997).

Although we may not be too concerned today with whether farming profits are partly rent, the problems that do concern us are just the same in nature. We are concerned with whether payments for software are for services or a royalty, with thin capitalization (in other words, whether a payment is interest or a dividend), and whether futures contracts come under the business profits, capital gains, or other income articles.⁷⁰ And that was before derivatives demonstrated that there was no real distinction between types of income so far as financial products are concerned. A recent example in the United Kingdom (the box spread), where we had to change the law, is instructive. In a box spread, by combining options, any change in the value of the underlying asset would cancel out, leaving only the interest element to be taxed as a capital gain, which is exempt in the hands of a unit trust (our version of mutual funds). This shows that it has taken a long time for us finally to appreciate that the four wise men were right long before derivatives and the Internet. There is no practicable way of distinguishing between different types of income under an income tax. All treaties do is encourage the creation of types of income, such as capital gains, which the source state cannot tax in the hands of a non-resident. There is no answer to this problem if we continue with tax treaties in the current form. If, as we have started to do in the EU, we abolish withholding taxes, this will recognize the reality of not being able to tax capital income, remove the problems of not being able to define different types of income, and remove the distortions on direct investment at the same time.

C. Qualification Conflicts

To my mind, one of the really clever things about the Model Treaty is article 3(2), which, in its latest form, reads:

As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

⁷⁰ For the diversity of views of this, see OECD, *Taxation of New Financial Instruments*, app. 1, ¶ 41 (1994).

Since an earlier version of this was first used in the U.S.-U.K. treaty of 1945,⁷¹ it must have been someone from one of our countries who thought of it. At first sight, it seems obvious that a treaty term should mean the same in both states, rather than have different internal law meanings in each of them; indeed, there are those who advocate this. But this approach overlooks that the tax systems in internal law do not have the same scope. Article 3(2) has the effect that the relieving provisions of the treaty correspond exactly to the taxing provisions of internal law. If expressions meant the same in both countries, this would not be the result. It would not lead to a sensible result if one country had a wider meaning of a type of income that it had to exempt than the other, and the treaty meaning was the same in both countries. The likely result would be that something covered by the internal law charge would not be exempt as a result of the treaty, or, less importantly, part of the treaty meaning would have no effect.

A problem that article 3(2) appears to encourage is for each state to use its own meaning of terms not only when relieving tax in the source state, which is mainly what the treaty is about, but also when it is giving relief as the residence state. This can lead to double taxation when the residence state says that if it had been the source state, it would not have taxed, so it will not give any relief for the tax that the source state, in fact, has charged because on its interpretation, the treaty does not prevent it. Or the reverse, when the residence state says that it would have taxed if it had been the source state, and so it will exempt the income even though the source state did not tax (although at least this problem does not arise in our countries as we, as the residence state, would tax and give credit for nothing). I do not believe that either result is intended by the Model Treaty; it would be a strange model treaty if it did. It would be nice if the Commentary said so plainly, rather than implying the reverse in an obscure section dealing with thin capitalization.⁷² I shall not set out the arguments here as my co-authors and I have written extensively about it.⁷³ It would be a considerable improvement to the Model Treaty and Commentaries if this point were clarified.

⁷¹ Income Tax Convention, Apr. 16, 1945, U.S.-U.K., art. II(3), reprinted in 2 Legislative History, note 51, at 2772.

⁷² OECD Commentary, note 31, art. 23, ¶ 68.

⁷³ See, e.g., John F. Avery Jones, Luc de Broe, Micheline van de Wiele, Maarten J. Ellis, Kees van Raad, Pierre Fontaneau, Pierre-Marie Fontaneau, Raoul Lenz, Henri Torriane, Thomas W. Magney, Toshio Miyatake, Sidney I. Roberts, Sanford H. Goldberg, Jakob Strobl, Jurgen Killius, Victor Uckmar, Federico Giuliani, Guglielmo Maisto & David A. Ward, Credit and Exemption Under Tax Treaties in Cases of Differing Income Characterization, 36 European Tax'n 118 (1996).

*D. Interpretation**1. The Status of the OECD Commentaries*

How important is the Commentary to interpretation? The Introduction to the Model Treaty states: "As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law."⁷⁴ One might expect the OECD to say that the Commentary contains the authentic interpretation that states are expected to follow unless they make an observation,⁷⁵ and perhaps to take steps to ensure that courts will pay attention to the Commentaries. On the contrary, the Introduction somewhat surprisingly proceeds to play down their importance: "Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of disputes."⁷⁶ Certainly, something less than binding effect is intended, particularly as there is no reference to the Commentaries in the treaty itself; they are merely something to assist in interpretation.⁷⁷ Why should the OECD have such low expectations for the Commentaries when it spends so much effort on updating them?

There is surely a case for saying in the treaty itself that it is intended to be interpreted in accordance with the Commentary in force at the time of its conclusion. I was particularly interested to see an example of this in the Memorandum of Understanding to the recent U.S.-Austrian treaty.

It is understood that provisions of the Treaty that are drafted according to the corresponding provisions of the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital shall gen-

⁷⁴ OECD Commentary, note 31, at Introduction, ¶ 29.

⁷⁵ "Observations on the Commentaries have sometimes been inserted at the request of Member countries that are unable to concur in the interpretation given in the Commentary on the Article concerned. These observations thus do not express any disagreement with the text of the Convention, but usefully indicate the way in which those countries will apply the provisions of the Article in question." *Id.* at Introduction, ¶ 30.

⁷⁶ *Id.* at Introduction, ¶ 29.

⁷⁷ The U.N. Commentary is stated to have similar effect: "If the negotiating parties decide to use in a treaty wording suggested in the United Nations Model Convention, it is to be presumed that they would also expect to derive assistance in the interpretation of that wording from the relevant commentary." U.N. Model Treaty, note 3, 1 Tax Treaties (CCH) ¶ 206.

erally be expected to have the same meaning as expressed in the OECD Commentary thereon. The understanding in the preceding sentence will not apply with respect to the following

- (a) any reservations or observations to the OECD Model or its Commentary by either Contracting State;
- (b) any contrary interpretations in this Memorandum of Understanding;
- (c) any contrary interpretation in a published explanation by one of the Contracting States that has been provided to the competent authority of the other Contracting State prior to the entry into force of the Conventions; and
- (d) any contrary interpretation agreed to by the competent authorities after the entry into force of the Convention.⁷⁸

There follows a reference to later Commentaries, which I set out below. Apart from item (c), which seems to be an attempt to give effect to your Technical Explanation in the other state by default, which would be better dealt with by obtaining the agreement of the other state to it as you did with Canada,⁷⁹ this is an interesting way of increasing the status of the Commentary. In terms of the Vienna Convention on the Law of Treaties,⁸⁰ this promotes the meaning in the Commentary to a special meaning where this otherwise would not be the ordinary meaning. Article 31(4) provides that "A special meaning shall be given to a term if it is established that the parties so intended."⁸¹ It would be interesting to know how this item of the Memorandum of Understanding arose because, so far as I know, it does not appear in any other treaty made by the United States or Austria.

There is an example of external documents being referred to as aids to interpretation of European legislation, the Convention on Jurisdiction, and the Enforcement of Judgments in Civil and

⁷⁸ Memorandum of Understanding Re Interpretation of the Convention, May 31, 1996, U.S.-Aus., 1 Tax Treaties (CCH) ¶ 703A.

⁷⁹ Department of Finance Canada News Releases 84-128 (Aug. 16, 1984) ("[C]anada agrees that the comprehensive technical explanation issued by the United States Treasury Department . . . accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the 1980 Tax Convention as amended."), and 95-048 (June 13, 1995) (containing a similar statement with respect to Treasury's technical explanation of the Protocol of March 17, 1995).

⁸⁰ Vienna Convention on the Laws of Treaties, May 23, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention].

⁸¹ Id. at 340; see Hugh J. Ault, *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, in *Essays on International Taxation* 64 (Herbert H. Alpert & Kees van Raad eds., 1993).

in question, but the taxpayer can, and probably will succeed if he does. It follows that the only fundamental changes that can have effect are those in favor of the taxpayer, which may not be quite what tax authorities sitting round the OECD table in Paris intend.

In relation to later Commentaries to the treaty in question, the Introduction says:

At that time [when the 1977 Commentary was being drafted], the Committee considered that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries, even though the provision of these conventions do not yet include the more precise wording of the 1977 Model Convention The Committee believes that the changes to the Articles of the Model Convention and the Commentaries that have been made since 1977 should be similarly interpreted.⁸⁴

They make an exception for changes to the Commentary resulting from amendments to the Model Treaty, and continue: "However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations."⁸⁵ It seems to me that too little attention is paid to the legal effect of later Commentaries in internal law, and I am doubtful about whether any legal weight should be given to the Committee's retrospective views about proper interpretation. Tax treaties are different from normal international treaties under which the contracting states can agree to any interpretation;⁸⁶ they are also part of internal tax law affecting taxpayers and subject to interpretation by courts in that country. In relation to the latter, these statements in the Introduction may be wishful thinking on the part of the members of the Committee rather than a statement of what the legal position actually is. This is a topic that should be researched further. Michael Edwardes-Ker's book on interpretation of treaties refers to only one decision of a Netherlands court that has discussed and approved the use of later Commentaries, as opposed to just doing so.⁸⁷

⁸⁴ Id. at Introduction, ¶¶ 33-34.

⁸⁵ Id. at Introduction, ¶ 35.

⁸⁶ Under art. 31(3) of the Vienna Convention on the Law of Treaties, subsequent agreements between the parties have the same status as context. Vienna Convention, note 80, at 340.

⁸⁷ Michael Edwardes-Ker, *Tax Treaty Interpretation* ¶¶ 26.05, 26.11, 26.12 (1995).

Commercial Matters, legislated in the United Kingdom in the Civil Jurisdiction and Judgments Act 1982, in which it is provided that “the reports by Mr. P. Jenard on the 1968 Convention and the 1971 Protocol; and the report by Professor Peter Schlosser on the Accession Convention, may be considered in ascertaining the meaning or effect of any provision of the Conventions and shall be given such weight as is appropriate in the circumstances.”⁸² This seems just the sort of provision that is required to give additional status to the Commentaries. It has the added advantage of dealing with the uncertainty about the status of the Commentary where only one or neither contracting state is an OECD member state but the Model Treaty has been followed. Presumably, the contracting states do want the meaning in the Commentary to apply but if they do not refer to the Commentary, how does anyone know that this is what they intended?

2. *The Status of Later Commentaries*

If the OECD suddenly came up with a better model, it would be a long time before it generally was adopted in practice and meanwhile, there would be a long transition while the existing 1,400 treaties were renegotiated. There is therefore a tendency to change the Commentary instead. The hope is that the new Commentary then will apply to all the existing treaties. As someone said, it is like the Bible; the words stay the same, only the commentary changes. Does anyone know what courts will do when they are faced with interpreting a treaty when the Commentary makes fundamental changes subsequent to the treaty? There are few cases so far, probably because many of the fundamental changes are recent. Unless there is a reasonable expectation that courts will give effect to some of the fundamental changes that are being made to the Commentary, and I doubt if this is the case, there is no point in making fundamental changes to the Commentary. In fact, from the point of view of the tax authority, changing the Commentary in this way could make matters worse. In light of statements in the Introduction to the Model Treaty that existing treaties should be interpreted in light of new Commentaries,⁸³ the tax authority may feel that it cannot properly argue against the interpretation contained in Commentaries made later than the treaty

⁸² Civil Jurisdiction and Judgments Act 1982, § 3(3), reprinted in Peter Kay, *Civil Jurisdiction and Enforcement of Foreign Judgements* 1804 (1987). For an example of use of the report by the European Court, see *Case C-432/93, SISRO v. Ampersand Software BU*, 2 WLR 30, 52 (1996), and by the English court, see *Pearce v. Ove Arup Partnership Ltd.*, 3 All ER 31, 40 (Chancery Div. 1997).

⁸³ OECD Commentary, note 31, at Introduction, ¶¶ 33-36.

Could one improve the status of later Commentaries, just as I have proposed improving the status of existing Commentaries? The Introduction mentions that the mutual agreement procedure might be used to clarify that the interpretation contained in later Commentaries applied.⁸⁸ This suffers from the same legal problem because the validity of an interpretative mutual agreement giving effect to later Commentaries depends on the constitutional law in each country.⁸⁹ A better solution is again found in the Memorandum of Understanding to the U.S.-Austrian treaty. The passage quoted above continues: "The Commentary—as may be revised from time to time—constitutes a means of interpretation in the sense of the Vienna Convention on the Law of Treaties of May 23, 1969."⁹⁰ I take this to mean that later Commentaries are a supplementary means of interpretation within article 32 of the Vienna Convention, that is to say something that can confirm the ordinary meaning derived from the usual methods of interpretation, or determine the meaning where the other method leaves the meaning ambiguous or obscure, or leads to a result that is manifestly absurd or unreasonable. At least this encourages the court to look at later Commentaries, rather than take the line, which is what I think we would say in the United Kingdom, that later Commentaries should not even be considered. Interestingly, two months after concluding that treaty, the Austrian courts confirmed that existing, but not later, Commentaries could be used for interpretation as an indication of the intention of the parties.⁹¹ Including such a treaty provision is also likely to mean that changes in the Commentary that genuinely clarify, rather than make major changes in the meaning, will be followed.

That in practice may be as far as one can go. To raise the status of later Commentaries further presents constitutional problems in that members of the tax authority, in their OECD capacity, can rewrite the Commentary, and thus the interpretation of the treaty, in their favor, by reflecting "the consensus of the OECD Member countries as to the proper interpretation of existing provisions"⁹² which is unlikely to appeal to Parliaments any more than it does to taxpayers. On the other hand, it does seem odd that if a country makes a new treaty today, which in a particular respect is in exactly the same form as an older

⁸⁸ OECD Commentary, note 31, Introduction, ¶ 33.

⁸⁹ OECD, *Linkages Between OECD Member Countries and Dynamic Non-member Economies 203-04* (Richard Vann ed. 1996).

⁹⁰ Memorandum of Understanding, note 78, 1 *Tax Treaties* (CCH) ¶ 703A.

⁹¹ Decision 92/13/0172 by the Austrian Administrative Court decided on July 31, 1996, discussed in M. Lang, *Later Commentaries of the OECD Committee on Fiscal Affairs, Not to Affect the Interpretation of Previously Concluded Tax Treaties*, 25 *Intertax* 7, 8-9 (1997).

⁹² *Id.* at 7 (citing OECD Commentary, note 31, at Introduction, ¶ 35).

one made with another country at the time of an earlier Commentary, the two treaties will have different meanings, which does seem contrary to the whole principle of having Commentaries. It is not as if parliaments (certainly in my country) take any notice of changes in the Commentary in approving treaties, particularly so when there is no mention of the Commentary in the treaty. If—and this may be a big if—parliaments were prepared to approve a statement in the treaty that it was to be interpreted in the light of the Commentaries from time to time in force, would this be desirable? It effectively would be a statement that the parties intended that a special meaning, determined in the future by the OECD, should apply, which as far as the two tax authorities are concerned, is of course exactly what they do intend, as the Introduction makes clear.⁹³

There must be a boundary between interpretation and change. If the later Commentary says that black now means white, there seems little doubt that article 32 will not help to give a treaty that interpretation. If, on the other hand, the parties have stated in advance that, as a special meaning to be determined later, black does mean white, a court might give effect to it. You may say that this is so extreme an example that it would never happen. Unfortunately, there are examples of the Commentary changing its meaning from black to white.⁹⁴ Hugh Ault has pointed out a complete change in the Commentary to article 17(2) in relation to income of entertainers being paid to another person.⁹⁵ In the 1977 Commentary, this was restricted to avoidance situations where the entertainer has control over the entity to which the income is paid.⁹⁶ In the 1992 Commentary, there is no reference to avoidance and it is stated that it includes, for example, payments to orchestras constituted as a legal entity, which is very different.⁹⁷ Another example is found in the Commentary to article 15. An employee is not liable to tax in the state in which he is working for less than 183 days if his remuneration is paid by, or on behalf of, an employer who is not a resident of the state in which he is working. There is therefore an incentive for an employee to be employed by a person in another state who lends his services to a person in the state in which he is to work. The 1992 amendment to the Commentary introduces the concept of the employer being the person having rights to the work produced and bearing the relative responsibility and risks, that substance should prevail over form, and a number of circum-

⁹³ OECD Commentary, note 31, Introduction, ¶¶ 33-36.

⁹⁴ Apart from the cases mentioned below, see Edwardes-Ker, note 87, ¶¶ 26.06-26.10.

⁹⁵ Ault, note 81, at 67.

⁹⁶ OECD Commentary, note 31, art. 17, ¶ 2 (History).

⁹⁷ Id. art. 17, ¶ 2.

stances are set out to establish this.⁹⁸ This interpretation can affect secondments within a group as well as abusive international hiring-out of labor. Previously, the expression “employer,” being an undefined term, would have been interpreted under internal law in accordance with article 3(2). If internal law looked to the legal relationship of employer and had no concept of an economic employer, this is a significant change. In the United Kingdom, the Inland Revenue is on record in saying that it will apply this Commentary to existing treaties.⁹⁹ Perhaps as a result, the effect of later Commentaries will now be tested in the courts.

If changes in the Commentary in the past had been restricted to what might be argued to be interpretation, there would be a strong case for an approach giving effect to future Commentaries as a special meaning, always assuming that parliaments would accept it. But, as the OECD has made such major changes to later Commentaries, it is very doubtful that this solution will now be acceptable. My conclusion is that the formula in the U.S.-Austrian treaty, enabling reference to be made to later Commentaries under article 32 of the Vienna Convention, is the right one, and this should be adopted generally. The extent to which the later Commentary has effect is in the hands of the court, which will not accept that a change from black to white is confirming the ordinary meaning or resolving ambiguities or obscurity, or avoiding manifestly absurd or unreasonable results. On the other hand, it is likely that more minor changes will be effective, which will assist the harmonization of interpretation of treaties. It is already the case that courts in many countries do refer to later Commentaries in the case of minor changes¹⁰⁰ and including something to that effect in the treaty will encourage courts in all countries to do so.

E. How Well Do Treaties Fit Together?

Tax treaties evolved, as I have shown, as separate bilateral deals standing on their own, which was a perfectly good approach when there were only a few of them. I should like to look at how well treaties work in three-country situations. You may be saying that things are bad enough when two countries are concerned. Is it really necessary to bring in three?¹⁰¹ The answer is that it is. Dual-resident com-

⁹⁸ Id. art. 15, ¶ 8.

⁹⁹ Inland Revenue Tax Bull. at 221 (June 1995). For criticisms of this in relation to existing treaties, see *Employees and Double Taxation Agreements*, 1995 Brit. Tax Rev. 529; *Debates on Treaties*, 1997 Brit. Tax Rev. 1.

¹⁰⁰ See Edwardes-Ker, note 87, ¶ 26.12.

¹⁰¹ One can have four countries involved, for example, in relation to interest paid by one permanent establishment to another.

panies can receive income from a third country and pay income to a fourth country. Similarly, a company resident in one state may have a permanent establishment in another to which income from a third country is attributable, or the permanent establishment may pay¹⁰² interest to a resident of a fourth country. A permanent establishment is a strange creature. Although not a resident, it shares with a resident the possibility of receiving income from a third state and paying interest and other sums to a resident of another state, and so it is different from a normal source of income. I try to avoid confusion in discussing three country situations by referring to countries in the manner of Bunyan's Pilgrims' Progress, like the town Vanity-Fair, the plain called Ease, Doubting Castle, and the Delectable Mountains, although much more prosaically as *Winner* and *Loser* (under a dual residence article), *HO* (*Head Office*), *PE*, *Source*, and *Recipient*. I refer to treaties in the form of *Source-HO* and the like.

1. *What Is the Definition of a Permanent Establishment in a Third State?*

A deceptively simple question to start with, if we are considering three countries, is what is meant by a permanent establishment in a third state. Paragraphs (1) to (4) of Article 5¹⁰³ of the Model Treaty apply to a permanent establishment anywhere, but paragraphs (5) to (7)¹⁰⁴ are all drafted in terms of a permanent establishment in a Contracting State. Do the latter provisions apply by analogy to third states, or are they inapplicable? The United States is the leader, as *Source*, in not reducing its withholding tax unless tax is payable in a third state, *PE*, when the other Contracting State, *HO*, is an exemption country.¹⁰⁵ So far as I know, the U.S.-Netherlands treaty was the first one to recognize the obvious problem. But have the negotiators

¹⁰² I use "pay" as a shorthand, meaning that the indebtedness on which the interest is paid is connected with the permanent establishment and the interest is borne by the permanent establishment. See OECD Model Treaty, note 2, art. 11(5), 1 Tax Treaties (CCH) ¶ 191.

¹⁰³ These relate to (1) the definition of permanent establishment, (2) examples of what constitutes a permanent establishment, (3) when a building site is included, and (4) exceptions to the definition.

¹⁰⁴ These relate to (5) agents having the authority to bind the enterprise being treated as a permanent establishment, (6) unless they are independent agents, and (7) that control of a company does not of itself constitute a permanent establishment.

¹⁰⁵ Income Tax Convention, Oct. 2, 1996, U.S.-Switz., art. 22, 4 Tax Treaties (CCH) ¶ 9101.22; Income Tax Convention, Apr. 3, 1996, U.S.-Lux., art. 24, 3 Tax Treaties (CCH) ¶ 5701.49; Protocol to Can.-Fr. Income Tax Convention, Nov. 30, 1995, art. 20, 96 TNI 53-32, Mar. 18, 1996, available in LEXIS, Fedtax Library, TNI File; Income Tax Convention, Aug. 31, 1994, U.S.-Fr., art. 30, 2 Tax Treaties (CCH) ¶ 3001.31; Protocol to U.S.-Neth. Income Tax Convention, Oct. 13, 1993, arts. 1, 2, 3 Tax Treaties (CCH) ¶ 6116.

read the definition of permanent establishment to see what it means in relation to a third state? I doubt it, but if anyone did, I am sure that they would agree that it ought to mean the same in relation to a third state as it does in relation to the Contracting States. There still could be problems if the definition of permanent establishment is different in the treaties between all three states concerned but, in practice, this is a lesser problem to that of whether the whole of the definition applies. Multilateral treaties at least reduce this problem by extending the definition of permanent establishment to all the states. Recent Australian treaties deal with third-state permanent establishments by adding at the end of the definition of permanent establishment:

The principles set forth in the preceding paragraphs of this Article shall be applied in determining for the purposes of this Convention whether there is a permanent establishment in a State other than one of the Contracting States and whether an enterprise other than an enterprise of one of the Contracting States has a permanent establishment in one of the Contracting States.¹⁰⁶

Perhaps this should be added to the Model Treaty.

2. *Application of Treaties to Income Received by a Permanent Establishment*¹⁰⁷

If one considers the receipts of the permanent establishment from third countries, *Source-HO* is the only treaty applying (this issue has been studied in the OECD Report on Triangular Cases).¹⁰⁸ In many ways, this is the wrong treaty, since *PE* has the prior, or sole (if *HO* is an exemption state), right to tax the income from *Source*. Is it heresy to ask why the treaty with *PE* should not apply?

As befits a triangular situation, there can be problems in all three countries. So far as *Source* is concerned, as I have mentioned, recent U.S. treaties prevent it, as *Source*, from reducing its withholding tax if there is no tax in *PE* or *HO*, as an exemption country, by specifying a minimum tax in *PE* as a condition for reducing withholding tax in its treaty with *HO*. Even where *PE* is a treaty country and not a tax haven, there are cases where *PE* will not tax foreign income attributa-

¹⁰⁶ Income Tax Convention, Aug. 6, 1982, U.S.-Austl., art. 5, 1 Tax Treaties (CCH) ¶ 503.11.

¹⁰⁷ For subsequent thinking on this topic, see John Avery Jones & Catherine Bobbett, *Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London*, 53 Bull. Int'l Fisc. Doc. 16 (1999).

¹⁰⁸ OECD, *Triangular Cases*, in *Model Tax Convention: Four Related Studies* 27 (1992) [hereinafter *OECD Triangular Report*].

ble to a permanent establishment, for example France (except for dividends and interest),¹⁰⁹ and Japan (with exceptions).¹¹⁰

Secondly, where *PE* does tax foreign income, there can be problems in obtaining credit for the *Source* tax because a permanent establishment is not a resident. The only requirement under the Model Treaty for *PE* to credit the tax in *Source* is under the nondiscrimination article of *HO-PE*, and then only if *PE* gives credit under domestic law, which some states (such as the Netherlands and Switzerland) do not, and in any case, many states, though I think not the United States, do not fully accept the obligation to give credits under the nondiscrimination provision, or have difficulty in giving credit in practice.¹¹¹ Another issue relating to such credit is that the tax charged by *Source*, being at the rate charged under *Source-HO*, will be different from that charged by *Source* to other taxpayers who are resident in *PE* for whom the *Source-PE* treaty will apply. The Commentary provides an optional clause allowing *PE* to give relief at the lower rate that would be charged under *Source-PE* if that treaty applied, but I am not aware of anyone adopting this in practice.¹¹²

Third, turning to *HO*, if it is an exemption state, it cannot give any relief for *Source* tax (about which I have already mentioned problems about credit in *PE*), and in any case, *HO* is not interested in certifying that the taxpayer is a resident of *HO* so as to enable it to obtain reduced withholding tax in *Source* as it is not taxing it on this income. If, on the other hand, *HO* is a tax-credit state, it is obliged to give credit both under *Source-HO* and *HO-PE*. If the credit given by *PE* for *Source* income is less than the tax charged by *Source* under *Source-HO*, difficulties can arise about credits, although the OECD Triangular Report states that most *HO* states give credit for the difference.¹¹³ (The problem dealt with in the OECD Triangular Report—

¹⁰⁹ Tax Treaty Problems Relating to Source, 1998 Brit. Tax Rev. 222, 234 n.74.

¹¹⁰ *Id.*

¹¹¹ OECD Triangular Report, note 108, ¶¶ 30-34. States that do not agree with this interpretation are listed in the Report as Ireland, Switzerland, and the United Kingdom (the court in *Sun Life Assurance Co. of Canada v. Pearson*, [1984] S.T.C. 461, considered that credit should be given under the treaty, but decided that this was prevented by the way the treaty was brought into force in internal law, so the United Kingdom might better be included as a country having problems of internal law, although it does give credit under internal law to nonresident banks on interest and nonresident insurance companies on income and gains). *Id.* ¶ 19 n.1. States that have problems in giving relief include Canada (except in the very narrow case of property held by a former Canadian resident that he elects to treat as "taxable Canadian property" when he becomes a nonresident of Canada), the Netherlands, and Italy (if foreign income is given a domestic source for taxing the permanent establishment). See Jones & Bobbett, note 107, at 235 n.77.

¹¹² OECD Commentary, note 31, art. 24, ¶ 52. The drafting was wrong, and was amended on October 23, 1997.

¹¹³ OECD Triangular Report, note 108, ¶ 35.

that there is an encouragement to set up a permanent establishment in a tax haven when *HO* is an exemption state—is less serious in this situation where there are treaties between all three states.)

There is an example of one possible treaty solution to the problem of a permanent establishment receiving third country income in the 1989 France-Italy treaty:

Where a permanent establishment situated in a State receives dividends, interest or royalties from the other State corresponding to property or rights effectively connected to its activities, such income shall be taxable in the State from which it is derived in accordance with the provisions of Article 10, paragraph 2.b), Article 11, paragraph 2 and Article 12, paragraph 2. The State in which the permanent establishment is situated shall eliminate double taxation according to the terms set forth in Article [the tax credit article]. This provision shall apply irrespective of the location of the head office of the enterprise on which the permanent establishment depends.¹¹⁴

This provision makes *Source-PE* an applicable treaty, but fails to deal with the other half of the problem by excluding the application of *Source-HO*, thus, if anything, making the problem worse as two treaties are then applicable, with the result that *Source* charges the lesser of the two withholding taxes. The OECD Triangular Report comments that a large majority of the Member countries were opposed to such a solution because it departs too much from the principles underlying the Model Convention and current practice.¹¹⁵ (Although, hopefully, I will not be accused of being unfair if I point out that, in relation to the two-state problem arising when *Source* and *HO* are the same state and *PE* the other, this is the Commentary's own solution.¹¹⁶ Under the Model Treaty, in that case, *Source* cannot tax dividends or interest attributable to the permanent establishment in *PE* at all. The Commentary suggests that *Source-PE* should apply so that *Source* can charge the treaty withholding tax rates, for which *PE* would give credit. Another point is that the France-Italy solution encourages treaty shopping by taxpayers setting up a permanent estab-

¹¹⁴ Income Tax Convention, Oct. 5, 1989, Fr.-Italy, art. 25, 97 TNI 131-25, July 9, 1997, available in LEXIS, Fedtax Library, TNI File.

¹¹⁵ OECD Triangular Report, note 108, ¶ 46. The Report also points out that if there is no *Source-HO* treaty, taxpayers may be tempted to maintain a permanent establishment in *PE* in order to obtain treaty benefits, but that is not a problem where there are treaties between all three states. *Id.* ¶ 44.

¹¹⁶ OECD Commentary, note 31, art. 21, ¶ 5, art. 23, ¶ 9.

lishment in *PE* to take advantage of *PE*'s favorable treaty with *Source*.¹¹⁷

I agree with the OECD that the France-Italy provision is not the solution to the three-state problem, particularly as it does not deal with *Source-HO*. I suggest that what is required is not to treat the permanent establishment as if it were a resident of *PE* in all cases, but for *HO* to transfer to *PE* the right in certain circumstances to claim to be the taxpayer's residence state, instead of *HO*, in treaties with third states.¹¹⁸ This requires an addition to article 4 to be contained in all relevant treaties between *Source*, *HO*, *PE*, and *Recipient*. Article 4 then would say that, in addition to a treaty resident of a state being a person who is liable to tax in that state under internal law by reason of the listed criteria, a person would be a treaty resident of a state in which there was a permanent establishment under any other treaty containing a provision to that effect. The circumstances in which such a provision might be contained in the *HO-PE* treaty could include the conditions that the income from *Source* was limited to dividends, interest, and royalties, that the income was fully taxable in *PE*, and that *PE* charged a normal withholding tax on payments of interest. The transfer of residence could be made conditional on *PE* actually giving credit for *Source* tax as if the taxpayer were a resident of *PE* (as opposed to being under a vague obligation to do so in the nondiscrimination article of *HO-PE* if it gave relief unilaterally).¹¹⁹ It would be possible for such a transfer under the *HO-PE* treaty to be revocable in case *PE* changed its law, but this would make it more difficult for third states to know whether the transfer was effective just by reading the treaty. This solution is a variation on the OECD's suggestion that *Source-HO* contain a provision that the taxpayer can obtain the benefit of that treaty when the income was attributable to a permanent establishment in *PE* only if there is normal taxation in *PE*.¹²⁰ Under the OECD solution, *HO* is effectively saying to *Source* that it is not the residence state if there is no tax in *PE*; under my alternative, it is saying that *PE* is the residence state instead of *HO* so far as *Source* is concerned, so long as there is normal taxation in *PE*. The alternative

¹¹⁷ OECD Triangular Report, note 108, ¶ 44.

¹¹⁸ This is analogous to *HO* giving up its right to charge tax as the source state of interest paid in favor of *PE*, as in OECD Model Treaty, note 2, art. 11(5), 1 Tax Treaties (CCH) ¶ 191, including doing so when the permanent establishment is in a third state (which *PE* is in relation to *HO-Recipient*) in accordance with the alternative in OECD Commentary, note 31, art. 11, ¶ 30. The disadvantage mentioned in the second and third indents of the OECD Triangular Report, note 108, ¶ 44, that *Source* would have to give treaty benefits to *PE* in a case where there was no *Source-HO* treaty, does not arise because I am assuming that there are treaties between all three states.

¹¹⁹ This meets the first point in the OECD Triangular Report, note 108, ¶ 44.

¹²⁰ *Id.* ¶ 55; OECD Commentary, note 31, art. 24, ¶ 53.

has advantages over the OECD solution as *HO* decides whether the condition about taxation in *PE* is satisfied in its treaty with *PE*, rather than generally, and, at the same time, it can ensure that *PE* really does give credit for third-state tax. The OECD suggestion still could be used by *HO* if it is an exemption state to deal with those cases where *HO* does not have a treaty with *PE*.

Many of the problems identified in the OECD Triangular Report are concerned with avoidance in cases where the permanent establishment is in a tax haven,¹²¹ does not tax foreign income, or has a favorable treaty with *Source*.¹²² Under the proposed solution, it is *HO* that decides whether to give *PE* the right to claim to be the taxpayer's residence state in its treaty with *Source*, and it will only do so if there is normal taxation in *PE* of income arising in a third state. The taxpayer is unlikely in these circumstances to be treaty shopping in setting up a permanent establishment in *PE*. Although the rate of withholding tax still may be lower under *Source-PE* than *Source-HO*, this is also true if the taxpayer forms a subsidiary in *PE* and, in any case, the income will suffer normal taxation in *PE*.

3. *The Source of Interest Paid by a Permanent Establishment*¹²³

Turning from the receipts of a permanent establishment to its payments, there is a problem about the source of interest paid by such a permanent establishment to a resident of *Recipient*. Application of the Model Treaty among the three states concerned gives rise to two different sources for the interest. In the *HO-Recipient* treaty, it is *HO* under the first sentence of article 11(5),¹²⁴ but in the *PE-Recipient* treaty, it is *PE* under the second sentence of that article.¹²⁵ Under the *HO-PE* treaty, which would apply if the interest was paid by the permanent establishment to a recipient in *HO*, the interest would have a source in *PE* only, as the second sentence of article 11(5) has priority over the first, but this applies only when the permanent establishment is in a Contracting State. When the permanent establishment is in a

¹²¹ OECD Triangular Report, note 108, ¶ 53.

¹²² Id. ¶¶ 39, 44.

¹²³ In this Section, I have drawn from an article on source by myself and my co-author. Jones & Bobbett, note 107.

¹²⁴ OECD Model Treaty, note 2, art. 11(5), 1 Tax Treaties (CCH) ¶ 191 ("Interest shall be deemed to arise in a Contracting State when the payer is . . . a resident of that State.").

¹²⁵ Id. ("Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.").

third state, both source rules apply. The Commentary says that there is no problem if there are treaties in the form of the Model Treaty among all three states.¹²⁶ I beg to differ. The fallacy is saying that the *HO-PE* treaty is applicable. It is not, because neither state is the recipient's residence state, and so article 1 is not satisfied. The dual source of interest is, of course, only a problem if *HO* regards the interest paid by a permanent establishment in *PE* as having a source in *HO* under internal law. The United States is, I think, a country, which, as *HO*, in some circumstances, would charge withholding tax on interest paid by anyone other than a financial institution but relating to a permanent establishment outside the United States.¹²⁷ Poor *Recipient* may be in the position of having to credit two lots of withholding tax, imposed by both *PE* and *HO*, and, of course, there may be limits, as there are in Canada,¹²⁸ on the credit they are prepared to give. I think that the statement in the Commentary has been wrong ever since the OEEC Fiscal Committee Fourth Report of 1961,¹²⁹ because article 1 dates from the earlier Third Report of 1960.¹³⁰ Looking again at article 1 may be necessary if triangular problems are to be solved.

The Commentary puts forward an alternative clause that provides that *PE*, even if it is outside both contracting states, is the source of interest, which eliminates *HO-Recipient* from applying.¹³¹ This was adopted in some 1960's treaties by the United Kingdom and Japan,¹³²

¹²⁶ OECD Commentary, note 31, art. 11, ¶¶ 29-30.

¹²⁷ IRC § 871(i)(2).

¹²⁸ Income Tax Act, R.S.C. 1985, c.1 (5th supp.), as amended § 126(1).

¹²⁹ OEEC, The Elimination of Double Taxation, Fourth Report of the Fiscal Committee (1961), reprinted in 4 Legislative History, note 51, at 4619.

¹³⁰ OEEC, The Elimination of Double Taxation, Third Report of the Fiscal Committee (1960), reprinted in 4 Legislative History, note 51, at 4565.

¹³¹ OECD Commentary, note 37, art. 11, ¶ 30.

¹³² The earliest use seems to have been between the United Kingdom and Japan in 1962. Convention for the Avoidance of Double Taxation, Sept. 4, 1962, Japan-U.K., art. VII, ¶ 2, 6 International Tax Treaties, note 5, at 184, 187-88. Extensions of that treaty still apply to Japan and the British Virgin Islands, Fiji, and Montserrat. Convention for the Avoidance of Double Taxation, Sept. 25, 1970, Japan-Virgin Is., art. VII, ¶ 2, available in LEXIS, Intlaw Library, IBFD File; Convention for the Avoidance of Double Taxation, Sept. 25, 1970, Fiji-Japan, art. VII, ¶ 2, available in LEXIS, Intlaw Library, IBFD File; Convention for the Avoidance of Double Taxation, Sept. 25, 1970, Japan-Montserrat, art. VII, ¶ 2, available in LEXIS, Intlaw Library, IBFD File. An extension of that treaty also applies to the United Kingdom and Singapore. Agreement for the Avoidance of Double Taxation, Dec. 1, 1966, Sing.-U.K., art. VII, ¶¶ 4-5, 8 International Tax Treaties, note 5, at 31, 35. This wording was not used in other U.K. treaties of the time. In Japan, this wording has been used subsequently in treaties with Korea, Malaysia, the United States, and Thailand. Convention for the Avoidance of Double Taxation, Mar. 3, 1970, Japan-Korea, art. 10, ¶ 5, 9 International Tax Treaties, note 5, at 191, 195 (different wording to the same effect); Agreement for the Avoidance of Double Taxation, Jan. 30, 1970, Japan-Malay., art. IX, ¶ 5, 9 International Tax Treaties, note 5, at 392, 396; Income Tax Convention, Mar. 8, 1971, Japan-U.S., 3 Tax Treaties (CCH) ¶ 5203.27, at 34,013 to 34,014; Convention for the Avoidance of Double Taxation, Mar. 1, 1963, Japan-Thail., art. VII, ¶ 5, 6 International Tax Trea-

but it had little effect since neither the United Kingdom nor Japan charges tax as *HO* in these circumstances. More importantly, it was used in some U.S. treaties between 1970 and 1984,¹³³ where it did have effect since it prevented you from charging tax as *HO* when interest was paid by a third state permanent establishment, which you otherwise would have done, but I have not been able to discover why you either adopted it or gave it up.¹³⁴ A provision having the same effect as the Commentary's alternative currently is adopted in all treaties by Australia,¹³⁵ but it is necessary there to prevent the treaty from creating a source of interest in *HO* to which the treaty would give effect for internal law as well because Australian treaties adopt treaty source rules for the purpose of internal law.¹³⁶ Presumably, the reason why the Commentary's alternative wording has not been adopted more widely is that it may result in *Source* giving up taxing rights in favor of *PE*, which does not charge any withholding tax on the interest. The solution does not need to be adopted in general. I suggest that it can be adopted when there is a treaty between *HO* and *PE* and only when *PE* imposes tax on the interest. Since this affects *Recipient* as a third state, it requires an express exception to article 1.

ties, note 5, at 262, 265. This amounts to five out of 18 Japanese treaties between 1962 and 1971, interestingly not including Japan-Australia, signed in 1969, which was about the time that Australia started to use the alternative wording. Agreement for the Avoidance of Double Taxation, Mar. 20, 1969, Japan-Austl., 9 International Tax Treaties, note 5, at 313.

¹³³ E.g., Income Tax Convention, Oct. 31, 1983, U.S.-Austl., 1 Tax Treaties (CCH) ¶ 503.55; Income Tax Convention, Oct. 13, 1972, U.S.-Belg., 1 Tax Treaties (CCH) ¶ 1303.12; Income Tax Convention, Aug. 16, 1984, U.S.-Can., 1 Tax Treaties (CCH) ¶ 1901.11; Income Tax Convention, Dec. 31, 1985, U.S.-Cyprus, 1 Tax Treaties (CCH) ¶ 2303.14. U.S. treaties with Iceland, Japan, Korea, Morocco, Norway, Phillipines, Poland, Romania, and Trinidad and Tobago employ similar wording. Some other treaties in this period did not include this wording. E.g., Income Tax Convention, Oct. 6, 1980, U.S.-Bangl., 1 Tax Treaties (CCH) ¶ 903.23; Income Tax Convention, June 17, 1980, U.S.-Den., 2 Tax Treaties (CCH) ¶ 2603.12; Income Tax Convention, Dec. 31, 1981, U.S.-Egypt, 2 Tax Treaties (CCH) ¶ 2703.13. U.S. treaties with Finland, Italy, Malta, New Zealand, the United Kingdom, and the former U.S.S.R. also did not include this wording.

¹³⁴ Giving it up in 1984 could have been connected with the portfolio interest rules adopted in the same year. IRC §§ 871(h), 881(c).

¹³⁵ Of the 29 Australian treaties made since 1969, only those with China and Poland do not contain this provision. Agreement for the Avoidance of Double Taxation, Nov. 22, 1985, Austl.-P.R.C., 23 International Tax Treaties, note 5, at 431 (Series B); Agreement for the Avoidance of Double Taxation, May 7, 1991, Austl.-Pol., 32 International Tax Treaties, note 5, at 121 (Series B).

¹³⁶ There are special reasons why this is necessary in Australia. Australian treaties contain a source rule stating that the source given in the treaty applies for internal law. E.g., Income Tax Convention, Oct. 31, 1983, U.S.-Austl., 1 Tax Treaties (CCH) ¶ 503.55. If the Model Treaty's wording were used, it would create a source in *HO*, thus causing the double source problem when it otherwise would not arise.

4. *Dual Residents and Third Country Treaties*

The other main triangular problem concerns dual residents. The relations between *Winner* and *Loser* when a person is a resident of both those states are well settled by the Model Treaty, which contains provisions to determine a single residence for the taxpayer for the purpose of the treaty.¹³⁷ What is not covered are the relations between those states and both *Source* and *Recipient*. Assume that the taxpayer is a resident of states *Winner* and *Loser*, and treaty resident in *Winner* for the purpose of *Winner-Loser*. It receives dividends, interest, or royalties from *Source* and pays interest or royalties (and where relevant, dividends) to *Recipient*. The existing situation is that *Loser* can charge only a withholding tax on domestic income, and cannot tax third-state income at all because of article 21 of *Winner-Loser*, unless it is attributable to a permanent establishment, in which case, it is the same as the normal permanent establishment considered above. In relation to third-country income, however, *Source-Winner* and *Source-Loser* both apply to the taxpayer's receipts. The effect is that *Source* can charge only the lower of the two treaty rates.¹³⁸

Winner-Recipient and *Loser-Recipient* also both apply to the taxpayer's payments of dividends, interest, and royalties, with the result that *Recipient* has to give relief for both states' withholding taxes. This problem is the same as the one I have considered for a permanent establishment. Payment of dividends by the dual resident to *Recipient* may be different because of article 10(5) of the Model Treaty, which prevents the source state (the prime example of a state that does this, although less commonly these days, being the United States) from taxing dividends or undistributed profits of a company resident in the treaty partner state. Where there is a treaty with *Recipient*, such a charge on the basis of source is already prevented by article 21 and so, the main use for this article is when there is no treaty with the third state, *Recipient*, which means that it is an implied exception to article 1. The question is whether article 10(5) is applicable to a dual residence case. There is a Dutch Hoge Raad (Supreme Court) decision,¹³⁹ and possibly a Canadian decision,¹⁴⁰ (I say possibly because Canada was both the source state and *Loser*) to the effect that

¹³⁷ OECD Model Treaty, note 2, arts. 4(2), (3), 1 Tax Treaties (CCH) ¶ 191.

¹³⁸ OECD Triangular Report, note 108, ¶ 1, at 28, suggests that there is no triangular problem in relation to dual residence because the relevant treaties are applied, but this does not deal with the potential conflict for *Source*.

¹³⁹ Sept. 2, 1992, No.27.252, BNB 1992/379. For comments on this decision, see Pieter M. Smit, *Taxation of Dividends Distributed by Dual Residence Company*, 33 *European Tax'n* 36 (1993); Kees van Raad, *The 1992 OECD Model Treaty: Triangular Cases*, 33 *European Tax'n* 298, 301 (1993).

¹⁴⁰ *Hunter Douglas Ltd. v. The Queen* [1979] D.T.C. 5340.

article 10(5) of the Model Treaty prevents *Loser* from taxing dividends paid to a third state, *Recipient*, although it seems that this provision is not aimed at a dual residence situation. The case to which it applies is where a company “which is a resident of [*Winner*] derives profits or income from [*Loser*].”¹⁴¹ In the situation I am considering, *Loser* is not taxing the dividends because of the derivation of profits or income out of which the dividends are paid, but on the ground that they are paid by a resident of *Loser*, which in treaty terms is the opposite of a charge based on source. Article 10(5) might be improved if it excluded the quoted words, which is the solution adopted in the U.S.-Canadian treaty¹⁴² and the 1996 U.S. Model Treaty,¹⁴³ thus making it clear that it also applies to dual residence cases.

Australian treaties, on the other hand, omit the quoted words but preserve *Loser*’s right to tax dividends.¹⁴⁴ If the solution in the U.S. Model Treaty is adopted generally, something then may need to be done in most countries to preserve the charge under the equivalent of your Subpart F legislation from being overridden by the prohibition of the charge on undistributed profits, although I assume that this is not a problem for you because of your saving clause.¹⁴⁵ A side effect of the change would be to prevent *Loser* from charging a withholding tax on dividends cashed in *Loser* (as in Belgium).¹⁴⁶ However, since *Loser* is already prevented from so doing by article 21 if the recipient is a resident of either *Winner* or any other treaty state, this does not seem very important and a state wishing to tax on this basis could include an exception in its treaties.

The only argument against *Loser*’s treaties with third states applying is that after applying the dual residence article, the taxpayer is no longer treated as a resident of *Loser* for the purpose of applying its treaties. The argument is that when it says in article 4(1) of the Model Treaty that a resident is a person liable to tax under *Loser*’s law, it means under that law as restricted by *Winner-Loser*, and accordingly, one applies the exclusion from being a treaty resident when the person is liable to tax in respect only of income from sources in *Loser*, in the second sentence of article 4(1). This argument seems unlikely to succeed although it has been taken by the Dutch Ministry of Fi-

¹⁴¹ OECD Model Treaty, note 2, art. 10(5), 1 Tax Treaties (CCH) ¶ 191.

¹⁴² Income Tax Convention, Aug. 16, 1984, U.S.-Can., 1 Tax Treaties (CCH) ¶ 1901.10.

¹⁴³ U.S. Model Income Tax Treaty, Sept. 20, 1996, 1 Tax Treaties (CCH) ¶ 214.

¹⁴⁴ U.S.-Austl. Treaty, note 136, ¶ 503.21.

¹⁴⁵ For an explanation that such a charge is not affected by the treaty, see OECD Commentary, note 31, art. 10, ¶ 37. In the United Kingdom, we recently had a case in which the court decided that the controlled foreign companies legislation was not overridden by a treaty, largely based on the interpretation of internal law. *Bricom Holdings Ltd. v. I.R.C.*, [1997] S.T.C. 1179, available in LEXIS, UKTAX Library, Cases File.

¹⁴⁶ OECD Commentary, note 31, art. 10, ¶ 35.

nance.¹⁴⁷ There is nothing in the Commentary to support this view. The example given in the Commentary is a person who, although not domiciled in the state, is considered to be a resident *according to the domestic laws* but is subject only to taxation limited to the income from sources in that state.¹⁴⁸ The other examples given are diplomats, whose privileges do not derive from tax treaties, but are merely confirmed by them,¹⁴⁹ and foreign-held companies exempted from tax on their foreign income by privileges, which necessarily are contained in internal law, tailored to attract conduit companies. The Commentary also provides that the provision is to be interpreted restrictively because otherwise countries adopting a territorial principle would be excluded from the scope of the treaty.

In the United Kingdom, Canada, and Australia, if one of those states is *Loser* under one treaty, the taxpayer is not a resident under internal law and accordingly is not a resident under its other treaties.¹⁵⁰ This is a simple internal law solution that does not appear to give rise to any problems, but it has other implications since it affects other internal law provisions, such as in the United Kingdom, the liability to account for advance corporation tax, or in the United States, it would affect the result of the control test in the definition of a CFC.

In the absence of this internal law solution, there is no doubt that one would wish to exclude *Loser's* treaties with third states from applying, leaving only *Winner's* treaties. This requires an addition to article 4 to be contained in all relevant treaties between *Source*, *Winner*, *Loser*, and *Recipient* saying that if under one treaty (*Winner-Loser*), a person is not a treaty resident of *Loser*, that person is not treated as a resident of *Loser* for the purpose of any other treaty to which *Loser* is a party. Article 4 therefore would provide that a treaty resident of a state was a person who is liable to tax in that state under internal law by reason of the listed criteria but excluding a state that was the loser under a dual residence provision of any other treaty. Because this solution would apply only if there were a treaty provision to that effect in *Winner-Loser* it would be agreed to by *Loser* only if *Winner* taxed income in the normal way, and exceptions could be included if this were not always the case. Such a provision would need to be expressed as an exception to article 1 because in some applicable treaties, neither state is the treaty residence state of the recipient of income. A similar solution is adopted in the Protocol to Belgium-

¹⁴⁷ Rijkele Betten, Denial of Certificate of Residence to Dual Resident Company, 29 European Tax'n 371 (1989).

¹⁴⁸ OECD Commentary, note 31, art. 4, ¶ 8.

¹⁴⁹ Id. art. 27.

¹⁵⁰ E.g., Income Tax Act, R.S.C. 1985, c.1, (5th supp.), as amended § 250(5) (the Canadian provision).

Netherlands (1970): "The expression 'under the law of that State' used in article 4, paragraph 1, means the law of the State as amended or supplemented by international agreements."¹⁵¹ But it should be noted that the taxpayer can be worse off under the solution. *Source* can at the moment charge the lesser of the rates under its treaties with *Winner* and *Loser*, and as the lower rate may be under the treaty with *Loser*, the rate of tax charged by *Source* may increase if the treaty with *Loser* is inapplicable. The Commentary also might put forward the suggestion of states adopting the internal law solution used by Canada, the United Kingdom, and Australia.

This solution involves a third state accepting that *Loser* is indeed the loser under the dual residence article of a different treaty, but if *Loser* is prepared to accept this and give up its taxing rights generally, it seems reasonable that a third state with much less interest in the matter should accept it. Preventing *Loser* from using treaties with third states has no effect on *Loser* so far as receipts from *Source* are concerned since under article 21 of *Winner-Loser*, it already is prevented from charging tax on third-state income unless it is attributable to a permanent establishment. So far as payments are concerned, if there is no permanent establishment in *Loser*, the source of interest paid is *Winner*,¹⁵² and *Loser* is again prevented from charging a withholding tax by article 21 of *Loser-Recipient*. If there is a permanent establishment in *Loser*, it charges withholding tax on interest paid in priority to *Winner*.¹⁵³

IV. CONCLUSION

On the wider issues with which I started, treaties cause problems by preventing change both to treaties and to internal law. They make distinctions between types of income that we now realize the wise men in 1923 were right in saying cannot be maintained.¹⁵⁴ Capital income is too mobile to tax effectively anyway. Withholding taxes cause distortions to direct investment. Should we not be looking for a solution that recognizes the globalization of taxpayers?

I have made four suggestions for improvement to tax treaties on the basis that we are locked into the present system. First, clarify the legal status of the Commentaries by referring to them in the treaty. Second, ensure that later Commentaries are at least considered by courts in interpreting treaties, also by making reference to the possibility of

¹⁵¹ Convention for the Avoidance of Double Taxation, Oct. 19, 1970, Neth.-Belg., Protocol ¶ II, 10 International Tax Treaties, note 5, at 113, 123.

¹⁵² OECD Model Treaty, note 2, art. 11(5), 1 Tax Treaties (CCH) ¶ 191.

¹⁵³ *Id.*

¹⁵⁴ See notes 49-53 and accompanying text.

their existence. Third, something should be stated about qualification conflicts. Fourth, as a modest step towards globalization, the Model Treaties should fit together better. I believe that all of these are simple to achieve and would go a long way to improve the present situation.