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Interpretation of Double Tax Convention – a Still Controversial Topic

1. Introduction

It was years ago when I first met the highly estimated colleague Prof. Nykiel. During the years I could observe his success in building up the science of tax law in Poland. One can only admire what is now the situation in Poland. In his honour, I dedicate some thoughts on a topic on that I have been working on for more than thirty years.

It is a strange situation: Art. 3 Para. 2 OECD Model Convention contains rules for the interpretation of double tax conventions (DTCs) in order to avoid controversies in the application of a DTC; but Art. 3 Para. 2 OECD Model itself is subject of a controversial[2] interpretation since the

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[2] See: J. Avery Jones, *A fresh look at Art. 3(2) of the OECD Model*, "IBFD" 2020, No. 11, https://research.ibfd.org/#/doc?url=/collections/bit/html/bit_2020_11_o2_2.html (accessed: 10.07.2012); M. Lang, *Tax treaty interpretation – a response to John F. Avery Jones*, "IBFD" 2020, No. 11, https://research.ibfd.org/#/doc?url=/collections/bit/html/bit_2020_11_o2_1.html (accessed: 10.07.2021); J.M. Mössner, *Auslegung von Doppelbesteuerungsabkommen – Auf ein Neues!*, [in:] D. Gosch, A. Schnitger, W. Schön (eds), *Festschrift für Jürgen Lüdicke*, C.H. Beck, München 2019, p. 485; *idem*, *Zur Auslegung von Doppelbesteuerungsabkommen*, [in:] K.H. Böckstiegel, H.E. Folz, J.M. Mössner, K. Zemanek, *Völkerecht, Recht der Internationalen Organisationen, Weltwirtschaftsrecht (Festschrift Ignaz-Seidl-Hohenveldern)*, Carl Heymanns, Köln 1988, p. 403; A. Rust, *Art. 3*, [in:] A. Reimer, E. Rust (eds), *Klaus Vogel on double Tax Conventions*, 4th ed., Kluwer Law International, Alphen aan den Rijn 2015, p. 207 et seq.; M. Lehner, *Die autonome Auslegung von Doppelbesteuerungsabkommen im Kontext des Art. 3 Abs. 2 OECD-MA*, [in:] J. Lüdicke, J.M. Mössner, L. Hummel (eds), *Das Steuerrecht der Unternehmen (Festschrift Frotscher)*, Haufe-Gruppe, Freiburg 2013, p. 383; K. Vogel, M. Lehner, *Doppelbesteuerungsabkommen: DBA*, 7th ed., C.H. Beck, Munich 2021, Art. 3, No. 97 et seq.; J. Avery Jones, *Qualification conflicts: the meaning of application in art. 3(2)*

time when the rule was inserted into the OECD Model.[3] One thing seems accepted: Art. 3 Para. 2 OECD Model has to be interpreted according to the rules of treaty interpretation as codified in the Vienna Convention of Treaties.[4]

In section three of this convention, the rules (Arts. 31–33) deal with the interpretation. The fundamental rule is found in Art. 31 Para. 1: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

Three elements are to be respected according to this rule:

1) the ordinary meaning of the terms,
2) the context, and
3) its object and purpose.

Art. 31 Para. 2 defines the context as the textual and legal environment in which the treaty is embedded. This means that the interpretation of an article of a treaty must take into account the meaning of this article in the light of other articles and the functioning of the whole legal instrument. The interpretation cannot be restricted to the article itself.

The ordinary meaning of a term is the linguistic approach, object, and purpose that leads to a teleological interpretation. And finally: What are the effects of the one or the other possible interpretation in the light of the whole treaty.

2. Linguistic interpretation of Art. 3 Para. 2 OECD Model Convention

The wording of Art. 3 Para. 2 runs as follows:

"As regard 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 the time under the law of the state for the purposes of taxes to which the convention applies,

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of the OECD Model, [in:] H. Beisse, M. Lutter, H. Närger (eds), *Festschrift für Karl Beusch zum 68. Geburtstag am 31. Oktober 1993*, Walter de Gruyter, Berlin–New York 1993, p. 43 et seq.

[3] For the history of the rule see: J. Avery Jones, *The interpretation of tax treaties with Particular Reference to Article 3(2) of the OECD Model – II*, BTR 1984, 14 et seq., 90 et seq., https://heinonline.org/HOL/LandingPage?handle=hein.journals/britaxrv1984&div=18&id=&page= (accessed: 10.07.2021).

[4] Vienna Convention on the Law of Treaties, 1969, Arts. 31–33 (quoted as Vienna Convention).

any meaning under the applicable tax laws of that state prevailing over a meaning given to the term under other law of that state."

One thing seems undisputable: the "terms" are the terms of tax law. But besides this, the questions arise: What is the application of the convention and who applies the convention? What is the function of "unless"? What is the "context"?

Let us take a simple example: A – resident of State X – is employed by an enterprise and works in State Y. He has an employment treaty for 10 years. After 7 years the enterprise undergoes a reorganisation and has no further need for the services of A. In a treaty, A and the enterprise agree that A leaves the enterprise and receives a severance payment. Which state has the right to tax this severance payment, X or Y? We assume that such payments according to the tax law of Y are taxed as a part of the salary paid to A, and under the tax law of X, this payment is taxed as other income.

3. The applying State

John Avery Jones[5] sees only the state of origin as the state which applies the convention.

The first question is: What does it mean to apply the tax convention? A legal norm is applied by a legal entity which is the addressee of the norm and whose legal position is touched. Avery Jones has several times stressed that the Arts. 6–22 OECD Model only concern the state of origin. States have by their sovereign position the right under international law to tax all economic events occurring in their territory.[6] This is not contested. The rules of a double tax convention are restrictions on this right to tax as far as the contracting states agreed upon: the so-called barring-effect of double tax conventions.

Looking at Arts. 6–23, indeed, the result is whether the state of origin may or may not tax. When reading the articles, one could have the impression that also the right to tax of the state of residence is touched. But if the articles give the exclusive right to tax to the state of residence, then it follows directly from Arts. 6–22 that the state of origin may not tax the item of income. On the other hand, if the article upholds the taxing rights of the state of origin

[5] J. Avery Jones, *Qualification Conflicts: The Meaning of Application in Article 3(2) of the OECD Model*, p. 45.

[6] For example, cf. American Law Institute, J.B. Houck, *Restatement of the Law. The foreign relations law of the Unites States*, "International Lawyer" 1986, Vol. I, p. 259 et seq.; K. Vogel, M. Lehner, *Doppelbesteuerungsabkommen*…, p. 169.

nothing is said for the state of residence in Arts. 6–22 but in Art. 23. Avery Jones is right: the state of origin is the state "applying" Arts. 6–22.

4. The meaning of "unless"

Taking into consideration the wording of Art. 3 Para. 2 it seems clear: a term of a DTC has the meaning under the tax law of the applying state. This interpretation has been called the national interpretation. The state of origin applies the notion of its tax law. For example: State Y treats a severance payment as part of a salary. A is working in an enterprise situated in Y, therefore, in the wording of Art. 15 of the OECD-Model "the employment is exercised" in that state and the payment may be taxed in the state of origin as part of the salary.

A different result could be achieved if the context requires otherwise. But the wording is not "if" but "unless". As Avery Jones several times[7] pointed out, this "unless" in English understanding describe a strict exception. Overwhelmingreasons must exist to depart from the national interpretation. And these reasons must derive from the context whatever this means.

The German relevant wording is as follows: "wenn der Zusammenhang nicht anderes fordert". This "wenn" (if) can be understood not as an exception of the national interpretation but as a condition for the national interpretation.[8] In understanding Avery Jones, the first step is the national interpretation and as an exception the interpretation according to the context. In understanding the German wording, it is the other way: first interpretation according to the context and as ultima ratio the national interpretation as second step. Many, if not most, German DTC are concluded in a version of the German language, and sometimes the version in a foreign language is not the English version.

This poses the question of the relevance of the OECD Model[9] for the interpretation of treaties in other languages and the question of the interpretation of multilingual treaties.[10] These are two questions that will

[7] See: "IBFD" 2020, No. 11.

[8] K. Vogel, M. Lehner, *Doppelbesteuerungsabkommen*…, Grundlagen Art. 3, No. 116a.

[9] K. Vogel, M. Lehner, *Doppelbesteuerungsabkommen*…, Grundlagen No. 123 et seq.; a topic often discussed, cf. O. Milanin, *Die Bedeutung des OECD-Musterabkommens für die Auslegung von Doppelbesteuerungsabkommen*, Nomos, Baden Baden 2021.

[10] R.X. Resch, *The Interpretation of Plurilingual Tax Treaties: Theory, Practice, Policy*, Universiteit Leiden, Hamburg 2018.

not be treated with in this article. But it seems clear that it is a difficult to answer the question whether the English version of the Model Convention must be observed when interpreting the DTC though an English version is not an authentic text of the DTC.

5. The meaning of "context"

According to Art. 31 of the Vienna Convention, the context is defined as any other relevant document or text agreed upon by the parties. The context, surely, is the double text convention itself. One article must be seen and interpreted in the light of the other articles. Besides this Art. 31 Para. 1 of the Vienna Convention demands the interpretation in the light of the object and purpose of the treaty. Both – context and purpose – are not the same but complete each other's. Context relates more to a systematic approach, a purpose to a more teleological one. Arts. 6–22 are in a strong relation to Art. 23. When discussing Arts. 6–22 one must also look at Art. 23.

6. The function of Art. 23 OECD Model Convention

Article 23 applies if the state of origin may tax the item of income according to Arts. 6–22. If the state of origin may not tax the income, nothing is said in Art. 23 because in this situation the taxing right of the state of residence is not restricted. It derives from the self-executing character of the treaty that the state of origin may not tax; it is barred from taxation. As a consequence, the taxing position of the state of residence is not touched in any way. But if the state of origin may tax; it is the obligation of the state of residence to grant relief of double taxation following the exemption or credit method.

The precondition for this obligation is that the state of origin taxes "in accordance with the provisions of the convention". What does this mean?

The controversial point in the interpretation of this term is whether taxation takes place if the state of origin applied its own tax law concept with the effect that it may tax the income (national interpretation) and the state of residence is bound to accept this interpretation,[11] or whether

[11] In this sense K. Vogel, M. Lehner, *Doppelbesteuerungsabkommen*…, Art. 232 No. 38 et seq.

the state of residence may also apply its domestic tax law in deciding whether the taxation took place in accordance with the provisions of the convention.[12]

The difference cannot be argued away[13] that if the credit method has to be applied in any way, double taxation is avoided by granting credit according to the national tax law, and the problem remains only under the exemption method. Countries like Germany[14] do not apply the nation law of granting credit if a double tax convention concerning income tax exists between Germany and the foreign state. Avery Jones' solution does not solve the case that, according to the national tax law of the state of residence, the state of origin may not tax.

The above example demonstrates very clearly the different positions. According to Avery Jones, state Y taxes according to the provisions of the convention, State X has to accept this and has to grant credit (or exemption). The other position is that State X, according to its national tax law, qualifies the severance payment as other income and applies Art. 21 giving that state the only right to tax. Both states tax as a result of double taxation. Alternatively, if X happens to be the state of origin and Y the state of residence, X would not tax because of the application of Art. 21 and Y would not tax because of Art. 15. If; however, as Avery Jones argues, the state of residence must always follow the qualification of the state of origin, and the result is that Y can also tax by applying Art. 21.

This example proves that it always would be Y which "wins" the conflict of taxing rights when following Avery Jones and that double or non-taxation would be the result when following the other interpretation giving the state of residence the right to also apply its domestic tax law.

7. Autonomous interpretation

In order to avoid these unsatisfying outcomes, many[15] prefer the so-called autonomous interpretation of the treaty by both contracting parties and applying only the national interpretation if the autonomous interpretation is impossible as ultima ratio.

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[12] Cf. J.M. Mössner, *Auslegung von Doppelbesteuerungsabkommen*…, pp. 490, 495 with further quotations.

[13] As Avery Jones tries, for example "IBFD" 2020, No. 11.

[14] Cf. J.M. Mössner, S. Seeger, I. Oellerich, *Körperschaftsteuergesetz Kommentar*, 4th ed., Herne 2019, Para. 26, No. 341.

[15] Cf. Lehner, *Die autonome Auslegung*…, pp. 383, 400.

In the given example, the German Federal Tax Court[16] interpreted Art. 15 in the way that the state of origin may only tax the remuneration if it is derived by the person as the counterparty for exercising services in that country. Severance payments are paid not for the services that are delivered but for the non-exercise and decided, therefore, that severance payments do not fall under Art. 15.

If both contracting parties interpret the rule only under the wording of the convention and do not take into account their national tax law the result will be that both states apply the rule in the same sense. No controversy of interpretation would exist and the convention functions perfectly. Because it is the object and purpose of the tax convention to eliminate double taxation this would be the best approach for the interpretation of the rules of the convention. In the light of Art. 31 of the Vienna Convention, the wording of the treaty must be interpreted in a way that object and purpose is best realized. The "unless" must be understood in a way respecting the purpose of the treaty.

It goes without saying that the autonomous interpretation does not in all situations avoid a different interpretation by the courts of the two countries. It is a common phenomenon that two courts even of the same state come to different results when interpreting a text. But the different interpretations of the same text would be clearly minimized by the autonomous interpretation in relation to the national interpretation.

John Avery Jones[17] argues, as far as I understand him, that the types of income within the treaty do not always correspond to the same types of income in national tax law and that, therefore, because of different qualifications of a given income, it may come to double or no taxation. To prove this, he presents the following example:

"A is a resident of the State R. He holds a participation in a partnership in R. At the same time, he is an employee of this partnership, and he works for this partnership in State S where the partnership does not dispose over a permanent establishment. The States R and S treat the income received by a partner of a partnership who is at the same time an employee of the partnership differently as business income or as income from employment. The dividing line between these two kinds of income in the treaty cannot be the same as in the national tax laws." According to Avery Jones, the treaty is ineffective if the national dividing line is narrower than the treaty's dividing line. I have a different view on this situation.

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[16] BFH (Federal Tax Court) decision 18.7.1973 – I R 52/69, BStBl (Official Journal of the Ministry of Finance), Vol. II, 1973 p. 757; decision 30.9.2020 – I R 76/17, BStBl II 2021, p. 275.

[17] "IBFD" 2020, No. 11.

Case 1: State S treats the income of A as income from employment. As A exercises his employment in this state without being a resident of this state, according to the tax law of S, A is taxable in this state.

(1a) According to the autonomous interpretation of the treaty, A receives income from employment (Art. 15). It follows that the taxation in S is upheld by the treaty and R has to gives relief from double taxation (Art. 23) by credit or exemption.

(1b) According to the double tax convention, A receives business income (Art. 7). Because there is no permanent establishment in S, Art. 7 DTC bars the taxation by S and only R may tax this income.

For case 1, in both possibilities, I fully agree with Avery Jones.

Case 2: According to the tax law of State S, the employee of a partnership who holds a share in the partnership is qualified as business income.

(2a) In the light of the autonomous interpretation of the DTC, A also receives business income. As there is no permanent establishment in S, this state may not tax this income.

(2b) The treaty upholds the taxation of State S as, according to its autonomous interpretation, says it is income from employment, but S applies its rules – business income – and does not tax A as there is no permanent establishment in S.

This seems to be Avery Jones' solution for Case 2. But there are objections against this result. These objections are based on the dogmatic structure of restricted tax liability.

A tax rule like the one differentiating business and employment income is not applicable by itself; on the contrary, the applicability to a given case is decided by a rule that belongs to the field of conflicts of law. These rules are in tax law are only unilateral other than in civil law where they are bilateral, which means the tax rule of State S only determines whether the national tax law of S is applicable to a situation or not, while in civil law the rules also say which state's law is applicable. In tax law, two types of such rules are known. First, the rule of residence – in its various criteria – is based on the relation of a person to a given country. A personal connection must exist between a person and a territory in the sense that the country is the centre of one's personal life. As a result, the whole tax law is applicable to world-wide income: the so-called unlimited tax liability. If such a connection does not exist, but the taxpayer receives income out of the country, the taxation is restricted to this kind of income and the rules of conflict of laws existing for this type. The states define in their tax law on the limited tax liability which is meant by "income out of the country" by stipulating the criterion for each type of income. These examples are exercising an activity within the country for employment income and the existence of a permanent establishment for business income. In example (2b) in State S, no rule of

the conflicts of law for business income is realized: there is no permanent establishment. Therefore, A is not subject to income tax on business income but only to income from employment as he exercises the activity within the territory of S, and he is an employee of the partnership.[18] The income tax rules on business income are not applicable to the case.

8. Conclusion

When taking all these aspects and arguments into consideration one could ask what the advantage is or even necessity of Art. 3 Para. 2 of the OECD Model. At the time when Art. 3 Para. 2 was inserted in the OECD Model the Vienna Convention did not exist. For a time after the existence of the Vienna Convention the question was what does Art. 3 Para. 2 add to this convention. The answer can only be: nothing apart from academic controversies on this unclear and disputable text of Art. 3 Para. 2. And a caveat: interpretation of a text means understanding the content of the text. This is always a difficult and comprehensive heuristic process that cannot be regulated by quasi mechanic rules.

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[18] See more on this: J.M. Mössner, *Theorie und Praxis im internationalen Steuerrecht*, [in:] J. Lüdicke, J.M. Mössner, L. Hummel (eds), *Das Steuerrecht der Unternehmen, Festschrift für Gerrit Frotscher zum 70. Geburtstag*, Haufe Gruppe, Freiburg–München 2013, p. 461; *idem, Isolierende Betrachtungseise*, [in:] F. Klein, H.P. Stiehl, F. Wassermeyer (eds), *Unternehmen Steuern: Festschrift für Hans Flick zum 70. Geburtstag*, Verlag Dr. Otto Schmidt KG, Cologne 1997, p. 939.

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Abstract

The article deals with controversies regarding the interpretation of tax treaties based on Art. 3 Para. 2 of the OECD Model in relation to Vienna Convention on the Law of Treaties.

Keywords: interpretation, tax treaties, the OECD Model, Vienna Convention on the Law of Treaties