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Challenges in Teaching Tax Treaties

1. Introduction

Professor Włodzimierz Nykiel and I share an interest in teaching tax treaties. The body of international tax law has grown exponentially during the period that he and I have been teaching this particular area of tax law. And within this area, the specialized domain of tax treaties has gained much prominence in that period. When I was enrolled in the 1960s as a student in the first tax law specialization program at Leiden University, which offered two full years of tax law, within that comprehensive program the lecture that was given on tax treaties did not last more than two hours. In the mid 1970s, when I started teaching tax law at that university as an associate teacher, I was given permission to teach a brief course in international tax law, including tax treaties. Ten years later, Leiden University decided to create the first chair in the Netherlands (and perhaps beyond), exclusively for international tax law, at which I had the privilege of being appointed. Just over another ten years, after the International Tax Center ('ITC') Leiden had been established, the tax treaty course I offered within ITC's Adv LLM Program in International Tax Law quickly developed into a format that comprised close to 200 hours of lectures and workshops. While that number may seem quite large, as a matter of fact, even within that comprehensive course many aspects of tax treaty law could be dealt with only in a summary manner.

In this contribution honoring Professor Nykiel I would like to use my experience of many years teaching tax treaty law as a basis for

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exploring a subject that may appear at first glance unproblematic but – as I discovered over the years – poses various issues that are challenging for teachers to fully explain and for students to quickly master. And one of these issues is the interaction between tax treaties and domestic tax law. Tax treaties take care of the overlap in taxation that occurs when a person that resides in one state derives from another state items of income that are taxed also by the latter state. Treaties aim at eliminating the resulting double taxation by distributing between the two states particular restrictions in the application of their domestic tax laws. These domestic taxing rules and treaty rules often use the same terms and that is where the problem lies, because the meanings of these terms, while usually quite similar, not rarely differ in important details. And, as we know, the devil is in the detail.

2. The interaction between domestic tax law and tax treaties illustrated on the basis of the notion 'permanent establishment'

Let us assume that a country with a domestic tax system that is in need of modernization not only wants to update its domestic taxing rules but also expand its tax treaty network. The country is fully aware that in treaty situations it can apply its domestic rules on the taxation of nonresidents only to the extent that the applicable treaty does not prohibit it from doing so. It therefore wants to keep the interaction between its (new) domestic taxing rules and the restrictions imposed by its tax treaties (typically based on the OECD Model) as uncomplicated as possible. With respect to business profits earned from its territory by nonresident entrepreneurs, it therefore wants to include in its domestic rules on taxation of nonresidents a provision that subjects the profits of nonresident entrepreneurs to tax only to the extent that such profits are earned through a local permanent establishment ('PE'), and define that term in its domestic tax law with exactly the same words as are used in the PE-definition of Art. 5 OECD Model.

This legislative move to keep things simple and effective seems smart but, as will be demonstrated below, it is – surprisingly perhaps – not. If one examines the PE definitions in the tax treaties concluded by a given country, even if the total number of those treaties is not very large, there will always be differences among the PE definitions. And those treaty definitions are important because for PE profits to be effectively taxable by the given state, the manner in which the business activities are carried on by a nonresident entrepreneur must not only meet the domestic PE definition (in order to be effectively taxable), but also the PE definition laid down in the applicable treaty (in order not to be restricted by the treaty). No matter how much a given country with respect to the PE definitions in its tax treaties would like to adhere to its own choices regarding the details of those treaty definitions (e.g., fully embracing the OECD Model or insisting on preferences regarding particular details), it will not succeed in having exactly the same PE definition in all of its treaties.

If the PE definition in a given treaty is not fully identical to the OECD Model definition, the treaty's definition may be wider or narrower than the OECD definition but will often be wider in some respects and narrower in other ones. To the extent the treaty PE definition is narrower than the domestic one, there will be instances in which the country in its role as PE state would like to impose tax under its domestic tax law but cannot effectively do so because of the restrictive PE definition in the applicable treaty. And the reversed situation will occur: the treaty includes a PE definition that is wider than the domestic definition, with the result that there will be instances where the activities in the PE state do not meet the domestic PE threshold while at the same time the pertinent treaty's PE definition is sufficiently broad to accommodate the PE state to tax if it could so under its domestic law.

Thus, the idea of avoiding issues by adopting a domestic law PE definition identical to the definition thereof in a country's tax treaties is a fallacy: it would only work if all those treaties would include a PE definition that is 100% identical to the OECD PE definition. And that will not happen: irrespective how hard a country will try in its treaty negotiations with other states to convince those states to fully adhere to the OECD definition, those countries will not be willing to give up their preference for particular adjustments of that Model PE definition.

A simple approach to avoid problems stemming from an incongruence in scope between the domestic threshold for taxing business profits earned by nonresident entrepreneurs and the treaty's PE definition would be to adopt a domestic PE threshold that is so low that it would accommodate virtually any thinkable treaty PE definition. Such a low threshold could e.g. read: 'engaging in business [in the given State] for more for than a single transaction'. The obvious consequence of this approach is that in cases where no tax treaty applies, such a low threshold will bring within the scope of the country's taxation a large number of marginal business undertakings, with all the drawbacks thereof, both for those businesses (which have to register as a nonresident taxpayer) and for the country's revenue service (which needs to administer all those nonresident taxpayers, many of whom will bring in very little if any revenue), and also possible adverse effects on the tax climate in that country for inbound business and investment.

An interesting alternative approach has been taken by France. In Art. 209 of its General Tax Code [*Code Général des Impôts*] it is provided with regard to tax liability of nonresident companies that '[…] subject to company tax are [also those] benefits […] in respect of which the taxation is attributed to France by an international double taxation convention'.[2] Thus, under this provision it is legally deemed that the French domestic taxing provisions cover all business profits derived from France by a nonresident company to the extent those profits are earned through a PE as defined in the applicable tax treaty. In other words, if a particular treaty would have an unusually wide PE definition that covers activities that would not be covered by the PE definitions that most countries have laid down in their domestic tax law, under the French rule that same wide treaty PE basis is assumed to be available under the domestic taxing rule.

Recently, a perhaps even better approach was adopted by the Netherlands. Since 2020 it is provided in various Dutch income tax statutes, that for taxation of business profits earned through a PE in the Netherlands by an individual or a company resident of a state with which the Netherlands has concluded a tax treaty, the (Dutch) PE notion is assumed to be identical to the PE definition in that tax treaty. Consequently, the Dutch domestic PE notion has become chameleonic: its meaning varies with the meaning the term has in the tax treaty applicable in the given instance. In this way there will, by definition, always be full congruence between the treaty and domestic PE notions. No issue can arise anymore with a domestic PE definition being wider than the applicable treaty definition (resulting in instances where income *may* be taxed under the treaty rule but *cannot* be taxed because of the short-falling domestic taxing rule) and the reversed situation (the treaty definition is wider, resulting in a missed domestic taxing opportunity).

[2] Translation by Kees van Raad. The (complete) French text of the article (only the words in *italics* appear in the English translation) reads: 'Sous réserve des dispositions de la présente section, *les bénéfices passibles de l'impôt sur les sociétés* sont déterminés d'après les règles fixées par les articles 34 à 45, 53 A à 57, 108 à 117, 237 ter A et 302 septies A bis et en tenant compte uniquement des bénéfices réalisés dans les entreprises exploitées en France, de ceux mentionnés aux a, e, e bis et e ter du I de l'article 164 B *ainsi que de ceux dont l'imposition est attribuée à la France par une convention internationale relative aux doubles impositions*'.

3. Difference between tax treaty and domestic law definitions of individual income items

Tax treaties eliminate double taxation through their distributive rules (Arts. 6–22 of the OECD Model) and double taxation relief rules (Arts. 23A and 23B). There are individual distributive rules for particular types of income, such as dividends and interest. These two income types are defined in Arts. 10.3 and 11.3, respectively. The treaty definitions of 'dividend' and 'interest' may differ from the domestic law definitions of these terms. To illustrate the issue, let us consider as an example that profit-sharing interest is by a given state treated as 'dividend' for purposes of that state's dividend withholding tax. For purposes of the (OECD Model based) treaty, profit-sharing interest is labeled as 'interest' by the treaty definitions in both Art. 10.3 (Dividends) and in Art. 11.3 (Interest).[3]

Let us first look at the difference between domestic law and treaties with regard to the *reason* for making a distinction between dividend and interest. Under the *domestic law* rules of many countries, an obvious reason for distinguishing dividend from interest payments is that interest is for the payor deductible for computing taxable profits whereas a dividend payment is not. And in various countries an additional difference is that the withholding tax rate for interest differs from the rate applied to dividends. Further, in some countries, while an outgoing dividend payment is subject to a withholding tax, outgoing interest payments are not covered by such a tax. Thus, for domestic tax purposes it clearly matters whether a given income item earned by a nonresident recipient is interest or a dividend.

In *tax treaties* dividend and interest are also distinguished but typically for only a single reason: the applicable tax rate: in the current OECD Model it is 15 or 5% for dividends (Art. 10) and 10% for interest (Art. 11). If in the two articles the tax rate would be the same, there would be no reason to distinguish between the two provisions and they could be combined into a single article 'Dividends and interest'. But the rates are different and therefore two articles are needed. But because of the difference in purpose for distinguishing between the two types of income, the dividing line between the two in the treaty may be quite different from the line

[3] Article 10.3 OECD Model: 'The term "dividends" as used in this Article means *income from* shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or *other rights, not being debt-claims, participating in profits*, as well as […]'. Article 11.3 OECD Model: 'The term "interest" as used in this Article means *income from debt-claims of every kind*, whether or not secured by mortgage and *whether or not carrying a right to participate in the debtor's profits*, and […]'.

drawn in domestic law; like in the example above: profit-sharing interest is for domestic law purposes assumed to be covered by the dividend withholding tax whereas in the treaty it is included in the definition of interest (and expressly excluded from the definition of dividend).

It is in this situation that the issue arises whether – taking into account the restrictions imposed by the tax treaty – the taxing state, dealing with an income item that is defined as 'interest' in the treaty but in domestic law is treated as a dividend for purposes of that state's dividend withholding tax, may subject that item to its dividend tax. When faced with this issue, many students will intuitively tend to deny the applicability of Art. 11 (Interest) and its maximum rate (10% of the gross amount of the payment) to the imposition of a domestic dividend withholding tax. Students are likely inclined to read the pertinent treaty definitions (the payment is interest) as setting aside the domestic law rules (application of a dividend withholding tax).

At this point it should be stressed that tax treaty definitions are applicable only for treaty purposes. Both the Art. 10 definition of dividend and the Art. 11 definition of interest include the words 'as used in this Article': i.e., their application is restricted to the tax treaty rules themselves. One of the well-known mistakes made by novel students of tax treaty law is to confuse treaty definitions and domestic definitions. And because tax treaties are in practice typically used in the same language version as the national language of the given country, such a confusion is understandable, and could perhaps be avoided if the treaty would be available only in a foreign language.

The habit that students need to develop is to examine in treaty situations first the application of the domestic taxing rules to the given cross-border item of income, without paying attention to anything in the treaty. The domestic law examination will produce a particular outcome. This domestic outcome is then put aside, after which the facts of the case are put again on the table to be examined now by the student with her or his 'tax treaty glasses' on: the facts are looked at exclusively from the perspective of the treaty definitions, i.e., completely disregarding the findings made earlier for domestic tax purposes. The examination of the treaty's distributive rules to these facts will result in a particular distributive rule being applicable which prescribes whether a – and, if yes, which – restriction must be observed by the taxing state in its taxation of the given income item. This restriction is then applied to the domestic law outcome that was established earlier.

This approach can be illustrated by the following example in which the treaty and domestic approaches have intentionally been made quite divergent. We assume that under a country's domestic tax law mortgage interest that is earned by a nonresident from a loan secured by a mortgage on local immovable property, is subject to ordinary net-basis income taxation. If the gross amount of the mortgage interest is 100 and there are deductible expenses of 20, the resulting net income is 80. If this amount is subject to a 30% income tax rate, the tax would be 30% of (100 – 20 =) 80 is 24. Without a tax treaty being applied, this 24 would be the amount of tax due. If an OECD Model type of treaty is applicable, we put aside this domestic analysis and computation (but remember the outcome: tax of 24) and put the facts back on the table for being scrutinized now for application of the tax treaty rules. We then first examine the various distributive rules of the treaty to be found in Chapter III: Arts. 6–21. Of these provisions, Art. 6 deserves attention as it could be imagined that for treaty purposes mortgage interest (being interest on a loan secured by immovable property) would perhaps be covered by the same rule of Art. 6 as ordinary income from immovable property. As a matter of fact, that was effectively done in some of the pre-WW2 model treaties developed by the League of Nations.[4] But OECD Model Art. 6 definition of immovable property income does not include mortgage interest, while at the same time this interest is expressly included in the Art. 11.3 definition of interest ('[…] income from debt claims […] whether or not secured by mortgage'). Consequently, the restriction imposed by the treaty on this payment is provided by Art. 11 of the treaty: it amounts to 10% tax on the gross amount of the payment: 10% of 100 is 10. The result is that the tax liability of 24 under domestic law is restricted by the treaty to 10. The domestic law taxing provision and the tax treaty restriction each walks it own way through its own set of rules.

Thus, it is essential to remember that in a tax treaty the names of the income items in the headings of the distributive rules are *unimportant*. The only thing that matters is the definition of the income item as provided in the applicable distributive rule (or, if not provided in that rule: as established through the interpretation rule of Art. 3.2, on the meaning of treaty terms that are not defined in the treaty). Therefore, continuing the example in the preceding paragraph, when we deal with profit-sharing interest that happens to be covered by the domestic-law dividend withholding tax of the source state involved, the question to be answered under the treaty is: is the income item covered by treaty Art. 10 (question to be answered on the basis of the definition in paragraph 3 of

[4] This treaty practice was continued by various states, particularly those that also in their domestic tax law subjected to tax on a net basis mortgage interest earned by nonresident recipients (e.g., the Netherlands continued such a rule in its domestic tax law until 1992 and, e.g., its current treaty with Israel still classifies mortgage interest as income from immovable property).

what is covered by that article) or Art. 11 (similar question). If the item is covered by Art. 10, the restriction on the tax by the source state is 15% or 5%, and if covered by Art. 11, it is 10%. It does not matter what is in the headings of the two articles, and neither does it matter how the income item is named in the domestic tax law of the taxing state. The only things that matters are: what is the tax due under domestic law, and, next, which restriction does the treaty impose on that tax?

4. Simultaneous application of divergent income definition rules of two treaties and their interaction with domestic law application

Occasionally a given cross-border income item may be subject to the restrictions that are simultaneously imposed by two (or more) treaties. This will typically occur in instances where the recipient of the income is a dual resident and each of the two residence states of this recipient has concluded a tax treaty with the state from which the income is derived.

An interesting and instructive situation arises if the treaties these two residence states have entered into with the source state differ from one another: if they provide for divergent treaty classifications of the given item of income. As an example we assume that (dual resident) recipient company R ('R Corp') receives from State S a profit-sharing interest payment amounting to 100. Under the domestic tax law of State S the payment is subject to a 25% withholding tax. Because of its incorporation, R Corp is considered to be a resident of State R.INC where it was incorporated. At the same time, based on its effective management, R Corp is also a resident of State R.EM where the company is effectively managed. State S has concluded a tax treaty both with State R.INC (the *S-R.INC treaty*) and with State R.EM (the *S-R.EM treaty*). The difference between these two treaties is that under the S-R.INC's treaty the profit-sharing interest payment is covered by the distributing rule of Art. 10 (note that I do not mention what is in the heading of this article, as this may trigger misguided ideas), and that article is assumed to provide for a 15% tax restriction on State S taxation of the gross amount of the income item. At the same time, the profit-sharing interest payment is covered by the S-R.EM treaty. Under that treaty (some of whose rules differ from those of the S-R.INC treaty) profit-sharing interest payments are covered by Art. 11. This article restricts the taxation by State S to 10% of the gross amount of the income item. Combining the effect of the two treaties, the tax liability under State S' domestic tax law of 25 is restricted to not more than 15 under the one treaty *and* not more than 10 under the other treaty. In combination, the effective restriction is the lower of the two: 10.

The example illustrates how to proceed in cross-border situations that are covered by one or more tax treaties. In such situations, the taxing rules (domestic law) and the restrictive rules (treaties) apply simultaneously. Each set of rules (State S law, S-R.INC treaty, S-R.EM treaty) operates in its own 'tax language' using its own terms and definitions. The effect that each set of rules has on the fact patterns to which they are applied, is determined in the 'tax language' of that particular rule set. How these different rule sets operate (i.e., how they establish and look at the relevant facts) does not matter; the only thing that counts is the outcome of the application of each set of rules. With regard to the domestic rules: whether the income item is taxable; and with regard to each of the two sets of treaty rules: whether the effect of their rules is that a restriction is imposed on the State S domestic law taxation. And all of that is individually determined in the different tax languages of the three sets of rules.

5. Conclusion

Tax treaties are fascinating subjects to teach. Students typically have earlier been trained to understand and master the complex rules of their own country's tax system. They have learned, e.g., how to determine the tax residence of a company, how to distinguish between dividends and interest for tax purposes, etc. But when they start dealing with tax treaties they need to learn to drop what they earlier learned and look at the facts from the perspective of another 'tax language' where terms may have an entirely different meaning. It calls for a seemingly simple approach that, in practice, however, requires a continuing effort to avoid the pitfalls of persistent reflexes.

Abstract

This contribution deals with the interaction between domestic tax law and tax treaties. It provides an illustration of this interaction on the basis of the notion 'permanent establishment'. Further, it deals with the difference that may exist between tax treaty and domestic law definitions of individual income items. It concludes with an explanation of the issues that arise when divergent income definition rules of two treaties need to be applied simultaneously and how such application of treaty rules interacts with the application of domestic law.

Keywords: tax treaties, interaction tax treaties with domestic tax law, permanent establishment