ARTICLE

The International Public Law Effectiveness Principle and Qualification Conflicts from a Dutch Perspective*

Frank P. G. Pötgens & Lucas J. de Heer **

In this article, the authors discuss the solution contained in the OECD Commentary for qualification conflicts. This solution would require the Residence State to follow the qualification of the Source State in certain situations. The Netherlands has made an observation to these provisions in the OECD Commentary. The authors discuss the distinction the OECD Commentary makes between qualification and interpretation conflicts. They argue that the Dutch observation is incompatible with the principle of effectiveness as derived from international public law and regret that the Dutch authorities maintained its observation in a recent renewal of its treaty policy.

1. Introduction

The Netherlands has one of the world's most extensive treaty networks. The policy-related infrastructure supporting the conclusion and maintenance of these treaties, that is, the Dutch tax treaty policy, has recently been revised and published in a report.[1] The Deputy Minister of Finance accommodated the many changes to domestic legislation, case law, and economic growth, as well as developments within the OECD that occurred since the last report which dated back to 1998 as one of the issues that required revision. However, the Dutch observation to paragraphs 32.1 et seq. of the Commentary to Article 23 OECD Model Convention has been left untouched.[2] Pursuant to its observation, the Netherlands remains of the opinion that, as Residence State, it should in principle be able to interpret the applicable tax treaty independently. The Commentary, however, requires the Residence State to follow the Source State's qualification in the event of a qualification conflict. By adopting this position, the OECD Commentary avoids double taxation arising in a number of situations, which is one of the main objectives of a tax treaty.[3]

In this article, the authors will examine whether, given this objective and the ensuing consequences of the position adopted in the OECD Commentary, the Dutch observation ought to have been waived in light of the principle of effectiveness that must be taken into account when interpreting tax treaties. The authors begin by discussing the solution proposed in the OECD Commentary for qualification conflicts and the Dutch observation regarding that solution (section 2). The authors will then outline the principle of effectiveness using case law from the International Court of Justice and literature (section 3) and discuss the significance of the principle of effectiveness for the Dutch observation (section 4). In conclusion, the authors will question the Dutch tax treaty policy (section 5).

2. OECD Commentary on Qualification Conflicts and the Dutch Observation

2.1. *Qualification Conflicts*

According to paragraph 32.3 of the Commentary to Article 23 OECD Model Convention, a qualification conflict arises if the source and Residence States apply different treaty provisions as a result of the reference to

Notes

* This is an amended version of an article previously published in *Weekblad fiscaal recht*, 2010, No. 6870, pp. 1024 et seq.

** Frank Pötgens is Professor of International and European Tax Law at the VU University Amsterdam and a tax lawyer at De Brauw Blackstone Westbroek N.V. in Amsterdam. Lucas de Heer is currently writing a PhD thesis on the tax aspects of Bilateral Investment Treaties. He is a tax lawyer at KPMG Meijburg & Co in Amstelveen.

1 *Memorandum Algemeen fiscaal verdragsbeleid (1987)*, Parliamentary Documents II 1987/88, 20 365, no. 2; *Memorandum Internationaal fiscaal (verdrags)beleid (1996)*, Parliamentary Documents II 1996/97, 25 087, and *Uitgangspunten van het beleid op het terrein van het internationaal fiscaal (verdragen)recht (1998)*, *V-N* 1998, No. 22. *Notitie Fiscaal Verdragsbeleid 2011*, Parliamentary Documents 2010–2011, 25 087, No. 7.

2 The verbatim text of para. 80 refers to para. 32.4 (example of an interpretation conflict) and para. 32.6 (double non-taxation) of the Commentary to the OECD Model Convention. Given the intent and wording of para. 80, one may assume that it also refers to the subparagraphs of para. 32 that are not explicitly mentioned, in particular, para. 32.3 (qualification conflicts).

3 See paras 1 and 3 of the Introduction in the Commentary to the OECD Model Convention.

domestic law in Article 3(2) OECD Model Convention.[4] For the interpretation of terms not defined in a tax treaty, Article 3(2) OECD Model Convention refers to the domestic law of the Contracting States applying that treaty, unless the context requires a different meaning.

Since 2000, and as a result of the Partnership Report implemented in the Commentary,[5] the qualification conflicts referred to above have been resolved by requiring the Residence State to follow the Source State's qualification. This position is based on the wording of Article 23 OECD Model Convention. The Residence State must provide double taxation relief (credit or exemption) for an income component that 'in accordance with the provisions of this Convention, may be taxed in the other Contracting State'. The OECD Commentary's recommendation for interpreting this phrase could indeed be read into this phrase, although the wording is not inconsistent with the position that the Residence State is not required to follow the Source State's classification. The authors consider the principle of effectiveness to play a prominent role in determining which interpretation is preferable (see also below, section 3).[6]

The solution for qualification conflicts proposed in the OECD Commentary has its origin in the International Tax Group.[7] An important difference with the International Tax Group's interpretation is the restrictive definition of qualification conflicts applied in the OECD Commentary.[8] The Commentary assumes that both states will apply Article 3(2) OECD Model Convention.[9] This means that if one of the two states does not apply Article 3(2) OECD Model Convention because, for example, its domestic law has failed to define a term that requires interpretation[10] or if the meaning attributed to it in domestic law is applied in a different context than that in the applicable tax treaty,[11] or if it has no specific legal meaning,[12] then this would involve a conflict of interpretation within the meaning of paragraph 32.5 of the Commentary to Article 23 OECD Model Convention.[13] Such an interpretation conflict must be resolved by means of the mutual agreement procedure of Article 25 OECD Model Convention.[14] The Commentary of the OECD Model Convention (paragraph 32.5 of the Commentary to Article 23) describes interpretation conflicts as differences that arise due to different interpretations of tax treaty

Notes

4 See *The Application of the OECD Model Tax Convention to Partnerships* (Issues in International Taxation No. 6), para. 102, Paris: OECD Publications 1999. Cf. also A.J.A. Stevens, 'Hybride entiteiten en belastingverdragen', *Maandblad Belastingbeschouwingen* 4 (2010): 139; K. Vogel, 'Conflicts of Qualification: The Discussion Is Not Finished', *Bulletin for International Taxation* 2 (2003): 41 et seq.; A. Rust, 'The New Approach to Qualification Conflicts Has Its Limits', *Bulletin for International Taxation* 2 (2003): 45 et seq.; and J. Sasseville, 'Klaus Vogel Lecture – Tax Treaties and Schrödinger's Cat', *Bulletin for International Taxation* 2 (2009): 46.

5 *The Application of the OECD Model Tax Convention to Partnerships*, *supra* n. 4.

6 Cf. also F. Engelen, *Interpretation of Tax Treaties under International Law* (Doctoral Series No. 7), 503–505, IBFD 2004.

7 J.F. Avery Jones et al., 'Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization', *European Taxation* 4 (1996): 118–146, and J-M. Déry & D.A. Ward, National Report Canada, IFA, *Interpretation of Double Taxation Conventions* (Deventer: Kluwer 1993), 259.

8 See also A. Ramos Huerta, 'Conflicts of Qualification and the Interpretation of Tax Convention Law', in *Conflicts of Qualification in Tax Treaty Law*, ed. E. Burgstaller & K. Haslinger (Vienna: Linde 2007), 25, who in such situations make a distinction between qualification conflicts in the broadest sense (for which the International Tax group also provides a solution) and qualification conflicts in the narrowest sense (as described in para. 32.3 of the Commentary to Art. 23 OECD Model Convention), which are the consequence of the reference to the domestic law of the Residence and Source States pursuant to Art. 3(2) OECD Model Convention. In this context, Ramos Huerta refers to a lecture by J. Sasseville (Lecture on Qualifications Conflicts in Tax Treaty Law, Academy of Public Accountants, Vienna, 22 and 23 Sep. 2006), who apparently applied a similar distinction. The Partnership Report (Ch. III, para. 94) also shows that para. 32.3 of the Commentary to Art. 23 OECD Model Convention seeks to resolve only qualification conflict problems in the narrowest sense: 'The Committee has found that a number of difficulties relating to the application of tax conventions to partnerships fall in the broader category of so-called 'conflicts of qualification', where the residence and source States apply different articles of the Convention on the basis of differences in their domestic law'.

9 Cf. also M. Lang, '2008 OECD Model: Conflicts of Qualification and Double Non-Taxation', *Bulletin for International Taxation* 5/6 (2009): 205, and E. Freddo, 'The Relevance of Art. 23A/B(1) OECD MC in the Case of Qualification Conflicts', in *Fundamental Issues and Practical Problems in Tax Treaty Interpretation*, ed. M. Schilcher & P. Weninger (Vienna: Linde 2008), 424 and 425. Cf. also Ph. Baker, *Double Taxation Conventions* (London: Sweet & Maxwell), 23-2/6 (loose leaf.), and J. Vleggeert, *Aftrekbeperkingen van rente in het internationale belastingrecht* (Fiscale Monografieën No. 132), (Deventer: Kluwer, 2009), 379.

10 Cf. Supreme Court 1 Dec. 2006, *BNB* 2007/75–79, where the Supreme Court did not apply Art. 3(2) of the tax treaties based on the OECD Model Convention that was part of the disputes in question, because Dutch tax law (to which those provisions referred) did not contain a definition of the term 'employer'.

11 Supreme Court 21 Feb. 2003, *BNB* 2003/177 and *BNB* 2003/178, where the term 'is present' in Art. 15(2)(a) of the Dutch tax treaties with Nigeria (1991) and Brazil (1990) that follow the OECD Model Convention on this point, was not used in a comparable context in domestic law, as a result of which Art. 3(2) of those treaties, which was the same as Art. 3(2) OECD Model Convention, could not be applied.

12 Cf. Supreme Court 29 Sep. 1999, *BNB* 2000/16 and *BNB* 2000/17; the term 'temporary' (*tijdelijk*) in Art. 10(2)(1) of the 1959 Germany-Netherlands tax treaty has no legal meaning and can therefore not be interpreted by reference to the interpretation provision of Art. 3(2) OECD Model Convention (Art. 2(2) of the 1959 Germany-Netherlands tax treaty).

13 For various examples, see Sasseville, *supra* n. 4, at 46. On p. 50, Sasseville argues that a qualification conflict within the meaning of para. 32.3 of the Commentary to Art. 23 OECD Model Convention can also be interpreted more broadly to the extent that it may also encompass the determination of transfer prices if it is based on domestic law. However, it is questionable if this can be argued, given the definition of qualification conflicts in the OECD Commentary. This definition assumes that the reference to domestic law will result in different allocation provisions of a tax treaty being applicable. However, the latter is not the case in Sasseville's hypothesis, because the fact that income must be considered business profit is not in dispute, although Sasseville does allude to this.

14 The mutual agreement procedure included in many tax treaties contains only a best efforts obligation for the competent authorities of the Contracting States and not a results obligation. After the amendments made to the OECD Model Convention in 2008, Art. 25(5) OECD Model Convention now provides for the possibility of arbitration. We note that, given the text of Art. 25(1) of the Commentary on Art. 23 OECD Model Convention (as of the 2008 amendments to the OECD Model Convention), arbitration is only possible if the specific case mutual agreement of Art. 25(1) OECD Model Convention is applicable and not the interpretative mutual agreement of Art. 25(3) OECD Model Convention. A similar arbitration clause has also been included in several recent Dutch tax treaties, e.g., the treaty with Ghana (2008), the United Kingdom (2008), Azerbaijan (2008) and Qatar (2008); see also I.J.J. Burgers, 'Structurering van bedrijven en recente ontwikkelingen in het internationaal belastingrecht', *Ondernemingsrecht* 6 (2010): 267.

provisions or different interpretations of the facts being followed.[15]

Solutions put forward elsewhere in the Commentary indicate that the OECD is aware that its definition of qualification conflicts is rather restrictive.

An example of this is paragraph 48 of the Commentary to Article 7 that was included in 2008: if both Contracting States apply different methods for the allocation of free capital to a permanent establishment (both methods being in accordance with the Authorized OECD Approach), the method applied by the State in which the permanent establishment is situated must be followed.[16]

Although the 2008 Commentary states that the difference in the allocation of free capital must be the result of the domestic law of the Contracting States, a difference in meaning regarding the capitalization of a permanent establishment will usually be the result of a different interpretation of the facts or of Article 7 OECD Model Convention and will therefore not be the result of domestic law.[17] Consequently, there will be no qualification conflict within the meaning of paragraph 32.3 of the Commentary to Article 23, but an interpretation conflict (in line with paragraph 32.5 of the Commentary to Article 23). In addition, as both Contracting States will apply Article 7 OECD Model Convention, as paragraph 32.3 of the Commentary to Article 23 requires, the application of different allocation provisions will no longer be an issue. These apparent inconsistencies in the Commentary could be resolved if the Commentary were to follow the position taken by the International Tax Group and amend paragraphs 32.1–32.7 of the Commentary to the OECD Model Convention accordingly.

Another example is provided by paragraph 8.10 of the Commentary[18] to Article 15 OECD Model Convention. Paragraph 8.10 was included in the Commentary to the OECD Model Convention as a result of changes made thereto in 2010. This paragraph states that, albeit in certain circumstances such as abuse or if the domestic law of the Employment State adopts a formal interpretation of the term 'employment'[19] the Residence State must follow the qualification of the Work State including the activities being carried out in an employment relationship with an enterprise that is a resident of the Work State. Accordingly, the Residence State must provide double taxation relief pursuant to Article 23 OECD Model Convention, with reference to paragraphs 32.1–32.7 of the Commentary on that provision.[20] Consequently, the Commentary disregards the circumstance that one of the states is not applying Article 3(2) OECD Model Convention, but applies, for example, an autonomous

Notes

15 If such interpretation conflicts lead to double non-taxation, then Art. 23(4) OECD Model Convention provides a specific provision. The Netherlands does not include such a provision in its tax treaties; see F.G.F. Peters, 'De verbindendheid van interpretatieve onderlingoverlegprocedures', *Nederlands Tijdschrift voor Fiscaal Recht (NTFR)* 1422 (2010): 4.

16 See, for example, paras 40–69 of the 'Discussion Draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention' of 7 Jul. 2008, which sought to provide a solution for the situation where both Contracting States use different transfer prices or transfer pricing methods, even though they met the at-arm's-length requirement of Art. 7(2) OECD Model Convention (profit allocation to a permanent establishment). Para. 44 of this Discussion Draft and the at-that-time-proposed Art. 7(3) OECD Model Convention stated that, if both states used different methods for the allocation of free capital that was in accordance with the at-arm's-length principle, the method applied by the State in which the permanent establishment was located was decisive. In the 'Revised Discussion Draft on a new Art. 7 of the OECD Model Tax Convention' of 24 Nov. 2009, these paragraphs were deleted and Art. 7(3) of the OECD Model Convention was replaced by the text proposed in the Discussion Draft of 7 Jul. 2008. The reason for this change was that the Contracting States would not apply a profit adjustment if the taxpayer's profit allocation is consistent with the newly proposed Art. 7(2) of the OECD Model Convention (profit allocation taking into account the separate entity approach). This was also included in the update to the OECD Commentary ('The 2010 Update to the Model Tax Convention') approved by the OECD Council on 22 Jul. 2010 (para. 48 of the Commentary to the new Art. 7 of the OECD Model Convention introduced in 2010). According to the 2010 Art. 7(3) OECD Model Convention, if the taxpayer applies a method of profit allocation to a permanent establishment that is not consistent with Art. 7(2), and one state therefore adjusts the profit, then the other state must apply a reciprocal adjustment (para. 53 of the 2010 Commentary to the new Art. 7). If the other state cannot agree to the adjustment made by the first state, the mutual agreement procedure, including the arbitration clause, must provide a solution; see para. 56 of the Commentary to the new Art. 7 OECD Model Convention. Cf. also Vleggeert, *supra* n. 9, at 350 and 363. Since the amendments to the Commentary to Art. 7 OECD Model Convention made in 2010, two versions of the Commentary now apply: the 2008 Commentary must be applied to Art. 7 OECD Model Convention; the major part of Dutch tax treaties have, to date, been based on this article. The 2010 Commentary must be followed if the 2010 version of Art. 7 is included in a tax treaty.

17 Cf. Vleggeert, *supra* n. 9, at 382.

18 'The 2010 Update to the Model Tax Convention' adopted by the OECD Council on 22 Jul. 2010. The origins of the newly introduced para. 8.10 of the Commentary to Art. 15 of the OECD Model Convention can be found in the Revised Public Discussion Draft, 'Revised Draft Changes to the Commentary on Paragraph 2 of Article 15', 12 Mar. 2007, (for a review of this Discussion Draft, see F.P.G. Pötgens, 'Proposed Changes to the Commentary on Art. 15(2) of the OECD Model and Their Effect on the Interpretation of "Employer" for Treaty Purposes', *Bulletin for International Taxation* 11 (2007): 476–488).

19 If such an employment situation is present, para. 8.7 of the 2010 Commentary to Art. 15 OECD Model Convention assumes that the person with whom such an employment situation exists is the employer within the meaning of Art. 15(2)(b) OECD Model Convention. What this position boils down to is that the definition of 'employer' is determined by first explaining the term 'employment' and subsequently defining 'employer' based on this explanation. Should this be regarded as an indirect, or direct, reference to the domestic law of the Contracting State or as an autonomous interpretation of the term 'employer'? The authors assume that, in this situation, the Commentary on Art. 15 OECD Model Convention follows the autonomous interpretation, since it assumes that an employer as referred to above is an enterprise to which the individual involved renders his or her services in an employment relationship. Para. 8.7 of the 2010 Commentary to Art. 15 OECD Model Convention draws this conclusion independently of the domestic laws of the Contracting States (see also F.P.G. Pötgens, 'Some Selected Interpretation and Qualification Issues with Respect to Article 15(2)(b) and (c) of the OECD Model', in *The 2010 OECD Updates – Model Tax Convention & Transfer Pricing Guidelines. A Critical Review*, ed. D. Weber & S. van Weeghel (Alphen aan den Rijn: Kluwer Law International, 2011), 131. The Discussion Draft of 12 Mar. 2007 also used a second interpretation method, whereby the definition of 'employer' was inferred from the letter and spirit of Art. 15(2) OECD Model Convention, and whereby also a potential domestic law definition of 'employer' was taken into account (para. 8.8 of the Commentary to Art. 15 OECD Model Convention proposed by the Discussion Draft of 12 Mar. 2007). However, this interpretation method was deleted in the 2010 update to the OECD Commentary.

20 The Netherlands did not, however, make an observation regarding para. 8.10 of the Commentary to Art. 15 OECD Model Convention (that has been included in the Commentary since the amendments made to the Commentary in 2010); (see also s. 2.2.) If the Residence State is of the opinion that the Work State did not apply the approach in question correctly and the Work State therefore did not tax the income in accordance with the provisions of the tax treaty, then the mutual agreement procedure must provide a solution.

interpretation. This is what the Netherlands has done in respect of the term 'employer' as defined in Article 15(2)(b) OECD Model Convention, thereby following the Dutch Supreme Court judgments of 1 December 2006, *BNB* 2007/75–79. In these judgments, the Supreme Court applied an autonomous interpretation of 'employer' in the absence of a definition thereof in the relevant domestic law and despite a definition of 'employment' in that same law.[21] The OECD Commentary also neglects the fact that certain states, such as the United States and the United Kingdom, have included a definition of 'employer' in their domestic law, and that when interpreting 'employer' they will apply Article 3(2) OECD Model Convention and that article's reference to domestic law. Although paragraph 8.10 of the Commentary to Article 15 in fact tries to achieve the result recommended by the International Tax Group, it is faced with the restrictive definition of qualification conflicts contained in paragraph 32.3 of the Commentary to Article 23.[22] Consequently, paragraph 8.10 of the Commentary to Article 15 conflicts with paragraphs 32.3 and 32.5, thereby undermining the Commentary's authority. It would therefore be advisable to amend paragraphs 32.1–32.7 OECD Model Convention so that they are consistent with paragraphs 8.10 of the Commentary to Article 15 OECD Model Convention.[23] The OECD report on 'Cross-border Income Tax Issues Arising from Employee Stock Option Plans'[24] and the implementation thereof in the Commentary to Article 15 OECD Model Convention of 2005 (paragraphs 12 et seq.) also struggle with the distinction between qualification and interpretation conflicts.[25]

2.2. *The Dutch Observation and Its Significance*

Each OECD Member States has the right to make an observation if they do not agree with an interpretation prescribed by the Commentary.[26] It can be argued that such an observation may be considered a unilateral interpretative declaration by the state making the observation, reflecting its position at the time a bilateral tax treaty was concluded.[27]

The OECD Commentary notes that observations 'usually indicate the way in which those countries will apply the provisions of the Article in question'.[28] However, it is possible to deviate from this position if the nature of the observation in question warrants this, as is the case, for example, if a state reserves the right to propose an alternative interpretation when negotiating or concluding a treaty with other OECD Member States. In this way, a state does not, by definition, rule out a different interpretation.[29]

As mentioned in section 1, the Netherlands has made the following observation to the OECD Commentary regarding qualification conflicts:[30]

> The Netherlands in principle is in favour of solving situations of both double taxation and double non-taxation due to conflicts of qualification between Contracting States, since in the Netherlands view such situations are not intended by the Contracting States and moreover go against the object and purpose of a tax treaty. However, the Netherlands does not agree with the interpretation given in paragraphs 32.4 and 32.6 to

Notes

21 See, for a discussion of these judgments, F.P.G. Pötgens, 'The Dutch Supreme Court Reaffirms and Clarifies "de facto employer" under Article 15 of the OECD Model', *Intertax* 2 (2008): 75–81.

22 See Pötgens, *supra* n. 19, at 136.

23 Pötgens, *supra* n. 19, at 135 and 136. A consequence of para. 8.10 is that the solution for qualification conflicts is applied to interpretation conflicts, while para. 32.5 follows the position that interpretation conflicts must be resolved via the mutual agreement procedure of Art. 25 OECD Model Convention.

24 OECD, Paris, 2004.

25 If the Residence and Source States take a different position on the tax base of capital gains (sale of shares), then the OECD report regards this as a qualification conflict (p. 9, para. 19). This is surprising, as inherent to a qualification conflict within the meaning of para. 32.3 of the Commentary on Art. 23 OECD Model Convention is the fact that the Residence and Source States apply different treaty provisions, while in the situation described in the report, one may assume that both states agree that Art. 13 OECD Model Convention applies. The OECD report considers a difference of opinion between the Residence and Source States regarding the allocation of option benefits to employment exercised in the Residence and Source States to be, on the one hand, an interpretation conflict (12, para. 29, OECD report), and on the other hand, a qualification conflict (6 and 7, paras 11 and 13, OECD report). See also F.P.G. Pötgens & M. Jakobsen, 'Cross- Border Taxation of Employee Stock Options: How to Improve the OECD Commentary – Part 1', *European Taxation* 8, no. 9 (2007): 417.

26 Paragraph 30 of the Introduction to the Commentary to the OECD Model Convention.

27 See also G. Maisto, 'The Observations on the OECD Commentaries in the Interpretation of Tax Treaties', in Liber Amicorum Maarten J. Ellis (Amsterdam: IBFD Publications BV, 2005), 73 et seq. Cf. also D.A. Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (Toronto/Amsterdam: IFA/Canadian Branch and IBFD Publications BV, 2005), 73, who took this position in part from para. 3 Introduction to the Commentary to the OECD Model Convention ('their tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax treaties that are based on the Model Convention').

28 Paragraph 30 of the Introduction to the Commentary on the OECD Model Convention.

29 Cf. Maisto, *supra* n. 27, at 84. See also para. 30 of the Introduction to the Commentary on the OECD Model Convention which states: 'Since the observations are related to the interpretations of the Articles given in the Commentaries, no observation is needed to indicate a country's wish to modify the wording of an alternative or additional provision that the Commentaries allow countries to include in their bilateral conventions'.

30 Paragraph 80 of the Commentary to Art. 23 OECD Model Convention.

the phrase 'in accordance with the provisions of this Convention' in Articles 23 A and 23 B of the Convention that in cases of conflicts of qualification that are due to differences in domestic law between the State of source and the State of residence as a rule the qualification given by the State of source would prevail for purposes of the application by the State of residence of Article 23 A or 23 B. The Netherlands wishes to preserve its right to subject a solution and its modalities for a certain conflict of qualification to the circumstances of the cases at hand and to the relationship with the Contracting State concerned. The Netherlands therefore will adhere to said interpretation in paragraphs 32.4 and 32.6 only, and to the extent which, it is explicitly so confirmed in a specific tax treaty, as a result of mutual agreement between competent authorities as meant in Article 25 of the Convention or as unilateral policy.

The Netherlands has therefore reserved the right to only apply the interpretation recommended in the OECD Commentary of the phrase 'in accordance with the provisions of this Convention, may be taxed' included in Article 23 OECD Model Convention if it is explicitly stated in a tax treaty, is the result of a mutual agreement procedure within the meaning of Article 25 OECD Model Convention, or is laid down in a unilateral policy decision. The authors consider that the observation made by the Netherlands clearly indicates that it does not intend to follow the interpretation regarding qualification conflicts recommended by the OECD Commentary. It is important that this position be taken into account when interpreting and applying tax treaties concluded by the Netherlands. If the observation is viewed in isolation, the Netherlands is therefore in principle not obliged to apply the interpretation endorsed in the OECD Commentary (however, see also section 3).[31]

In our view, the initial conclusion stated above would not be otherwise even if the following statement made by the Deputy Minister during the parliamentary debate on the ratification of the Amending Protocol of 8 March 2004, on the treaty with the United States is taken into account:[32]

Question 1: Dividends (Article 10(3))

(…) In response to the questions posed by these members I would like to remark that the assessment of whether a hybrid entity has a direct interest or is the beneficial owner is based on the assumptions set out in the OECD report 'Application of the Model Tax Convention to Partnerships' published in 1999. The Netherlands endorses the report's conclusions that, briefly put, are aimed at the avoidance of double taxation or double non-taxation in cases involving entities that are qualified differently by the source and Residence States. The fact that the receiving (residence) State's qualification of the dividend-receiving entity also, in principle, determines the status of the dividend payment is a key assumption in the OECD report. To that extent the Source State follows the Residence State's qualification (…).
For the sake of completeness, I note that the observation made by the Netherlands regarding the abovementioned OECD report does not relate to the report's conclusions. The observation made by the Netherlands was based on the fact that fundamental amendments to the OECD Commentary made after a bilateral tax treaty has been concluded do not, according to Supreme Court case law, automatically apply to the application of an existing treaty.[33]

While this quote refers to another paragraph of the Commentary, it is closely related to the paragraphs regarding qualification conflicts, the more so because both are a consequence of the implementation of the Partnership Report in the OECD Commentary, the conclusions of which are endorsed by the Deputy Minister of Finance. In situations where the source and Residence States characterize partnerships differently, that is, one state treats partnerships as transparent for tax purposes, while the other considers such partnerships opaque, the Source State must, when applying a tax treaty to such a situation as part of the factual context in which the treaty is to be applied, take into account the way in which an income component arising in its jurisdiction is treated in the jurisdiction of the person claiming the benefits of the treaty as a resident.[34] In other words, the characterization of the partnership by the Residence State prevails. If, therefore, the partners' Residence State considers that a partnership must be considered transparent, then the Source State must follow this characterization for the purposes of the tax treaty, notwithstanding the fact that the partnership is considered opaque under the Source State's domestic law. The Netherlands has made an observation on these types of situations in paragraph 27.1 of the Commentary to Article 1 OECD Model Convention. As regards its purpose, this observation can

Notes

31 See also A.-G. Wattel, Advisory Opinion to Supreme Court judgment, 1 Dec. 2006, *BNB* 2007/75, 4.7, and the appendix to this Advisory Opinion, points 8.12 and 9.8. Cf. also E.C.C.M. Kemmeren & L.G. Zuliani, 'Netherlands National Report', IFA, *Double Non-taxation*, p. 561, SDU 2004 and F.A. Engelen, 'Fiscaal Verdragsbeleid en het OESO-Modelverdrag', *Weekblad fiscaal recht* 6903 (2011): 549 and 550.

32 Further Additional Report (*NNV*), Parliamentary Documents I 2004/05, 29 632, no. C, 9.

33 Unofficial translation by the authors.

34 Paragraphs 6.3 and 6.4 of the Commentary to Art. 1 of the OECD Model Convention.

be compared to paragraph 80 of the Commentary to Article 23 OECD Model Convention, that is, the observation made regarding the solution for qualification conflicts proposed in the OECD Commentary.

The Netherlands appears to moderate its observation by its endorsement, in principle, of the Partnership Report (this also appears to apply to the position on qualification conflicts set out in the OECD Commentary: the last part of the quote refers in general to the conclusions of the Partnership Report), but considers that Supreme Court case law does not allow fundamental amendments to the OECD Commentary to affect earlier concluded tax treaties. However, it fails to specify which Supreme Court judgments it is referring to. According to Supreme Court case law, no legal expectations can be derived from statements made by the Deputy Minister during the legislative process and therefore made in his capacity as co-legislator.[35] To this extent, the observation therefore remains intact. This moderation is surprising in light of the general observation made by the Netherlands in Annex II with regard to the Partnership Report and which is based on the following arguments:[36]

– it is debatable whether the specific conclusions reached can be said to fully and directly flow from the original intentions underlying the respective tax treaty articles;

– the conclusions and the arguments put forward are not always consistent; and

– in general, it can be argued that the desire to find a solution has prevailed over whether there is a legal basis for the solution.[37]

Furthermore, according to Annex II it is uncertain whether the Netherlands will be able to implement the report without amending its domestic law, and it is debatable whether the report offers an integral solution for all situations involving legal and economic double taxation and double non-taxation of partnerships. According to Annex II, the Netherlands has therefore reserved the right to decide on its own initiative and depending on the specific circumstances of each case, whether and to what extent the conclusions of the report apply;[38] the manner in which the Netherlands has dealt with these problems in recent tax treaties appears to confirm this.[39] In addition, this also follows from the 2011 Dutch tax treaty policy memorandum.[40] The memorandum reconfirms that the Netherlands is only willing to support the conclusions of the OECD partnership report as regards the tax treaty characterization of partnerships if they explicitly follow from a tax treaty, a mutual agreement or unilateral policy.[41]

This is not only completely different to the qualification made during the parliamentary debate on the treaty with the United States, but it also clarifies the nature of the previously mentioned observations to the Commentary, including the observation relating to the solution for qualification conflicts recommended in the OECD Commentary. One may therefore assume that by making this observation the Netherlands has declined to follow the OECD Commentary in respect of qualification conflicts and the Commentary's divergent position on the characterization of partnerships.[42] As indicated above, this is confirmed by the 2011 Dutch tax treaty policy memorandum upholding the observation with respect to the OECD Commentary's view on the tax treaty characterization of partnerships.[43] In the authors view, it is striking that this memorandum pays no attention to the OECD Commentary's approach with respect to qualification conflicts (paragraphs 32.1–32.7 of the Commentary to Article 23 of the OECD Model Convention) or to the Dutch observation thereto (paragraph 80 of the Commentary to Article 23 of the OECD Model Convention).

Notes

35 Cf. Supreme Court 21 Sep. 2007, *BNB* 2008/91 and *BNB* 2008/92, and Supreme Court 7 Jul. 1993, BNB 1993/336.

36 In his letter to the First Chamber of 3 May 2005, Parliamentary Documents I 2004/05, 29 632, No. H, 14, regarding the Protocol Amendment to the treaty with the United States, the Deputy Minister of Finance reiterates the observation to the OECD Commentary on qualification conflicts. Cf. also Explanatory Memorandum (*MvT*), Parliamentary Documents II 2009/10, 28, on the tax treaty with the United Kingdom (2008) that entered into force for the Netherlands on 1 Jan. 2011.

37 Paragraph 20 of Annex II to the OECD Report, *The Application of the OECD Model Tax Convention to Partnership*, *supra* n. 4.

38 See also para. 21 of Annex II to the OECD Report, *The Application of the OECD Model Tax Convention to Partnership*, *supra* n. 4.

39 A specific provision was included in the treaties with Belgium (2001), Bahrein (2008), Ghana (2008), Poland (2002), South Africa (2005), and Switzerland (2010), prescribing the mutual agreement procedure for resolving qualification conflicts. Recent tax treaties with the United States (protocol 2004), the United Kingdom (2010), Albania (2004), Switzerland (2010) and Belgium (2001) contain a provision that is specifically aimed at resolving the problems surrounding hybrid entities under tax treaties (for an analysis of the various tax treaty provisions on this aspect see G.K. Fibbe, A.W.G. Lamers & A.J.A. Stevens, 'De Nederlandse fiscale behandeling van hybride entiteiten onder belastingverdragen', *Maandblad Belastingbeschouwingen* 5 (2011): 207–223). According to G. Fibbe, *EC Law Aspects of Hybrid Entities* (Doctoral Series No. 15), 286–289, IBFD 2009, the fact that the Netherlands, in a tax treaty with another EU Member State, such as Belgium, includes a solution for hybrid entities that follows the basic assumptions of the OECD Commentary for which an observation was made has certain European law implications. Fibbe argues that as a result of European law tax treaties concluded with EU Member States in which no such solution was included will also be affected, thereby negating the effect of the observation.

40 *Supra* n. 1, at 35 and 36.

41 *Supra* n. 1, at 35.

42 See also Peters, *supra* n. 15, at 4, and Stevens, *supra* n. 4, at 140.

43 *Supra* n. 1, at 35 and 36.

2.3. *The Position of the Supreme Court*

The Supreme Court appears to implicitly confirm the Dutch observation in its judgment of 1 March 2002, *BNB* 2002/153.[44] It should be noted, however, that the Supreme Court did not explicitly refer to that observation and that the validity and accuracy of the observation were not at issue in *BNB* 2002/153. Furthermore, the fact that the implementation of the Partnership Report in the OECD Commentary took place in 2000, while the former tax treaty with Belgium on which the Supreme Court had to render a judgment in *BNB* 2002/153 dated back to 1970, may also have also played a part. *BNB* 2002/153 concerned a fisherman (X) who resided in the Netherlands and who worked aboard a cutter flying the Belgian flag. This cutter was owned by A NV, a company having its registered office in Belgium. A NV was partner in a partnership in which X participated as fisherman. The Dutch tax authorities qualified X's income as business profit. However, the Belgian tax authorities qualified X's income as employment income, for which the right to levy taxes had been assigned to Belgium pursuant to Article 15 of the 1970 tax treaty with Belgium (comparable to Article 15 of the OECD Model Convention). In dispute was whether the Netherlands was obliged to provide double taxation relief pursuant to Article 24(1)(2) of the former treaty with Belgium (comparable to Article 23 of the OECD Model Convention). To paraphrase this provision: 'the Netherlands allows a deduction for the income … (that), may be taxed in Belgium according to (Article) 15(1) (…), of the Convention'. The Supreme Court stated that this tax treaty had not defined the term 'employment' used in Article 15(1) (income from dependent personal services). It was not to be interpreted pursuant to the law of the Source State (in this case Belgium),[45] but the Netherlands, as Residence State, was allowed to interpret this term independently and pursuant to its own legislation.[46]

According to the Dutch interpretation, there was no authority relationship, which is an essential criterion in classifying income as income from employment. Contrary to the Belgian position, the Netherlands argued that the income did not qualify as income from employment, but as business profit to which Article 7 of the underlying treaty (business profit) applied. As there was no permanent establishment, the right to tax the profit that X was entitled to was assigned exclusively to the Netherlands.

3. Principle of effectiveness

To the best of our knowledge, Engelen was the first to note the importance of the principle of effectiveness for the interpretation of tax treaties.[47] The principle of effectiveness is based on two individual principles:

– the principle that all *individual* treaty provisions must be considered to have been drafted for the purpose of achieving a specific effect, so that every interpretation that results in a treaty provision becoming a dead letter is contrary to the principle of effectiveness;

– the principle that the treaty *as a whole* is based on a specific objective, whereby any interpretation that prevents that objective been attained is also contrary to the principle of effectiveness.[48][49]

The International Law Commission argues that if a treaty provision and/or the letter and spirit of the treaty is open to two different interpretations, whereby (1) one interpretation makes the effective implementation of a treaty possible and (2) the second interpretation does not make the effective implementation of the treaty possible, then good faith and the letter and spirit of the treaty arising from Article 31(1) of the Vienna Convention demand that interpretation (1) be followed.[50][51] Article 31(1) Vienna Convention therefore forms the basis for the principle of effectiveness. This article requires Contracting States to interpret treaty provisions in good faith and in accordance with the context, letter and spirit of the treaty, a position that was confirmed by the International Court of Justice in its judgment in the *Libya v. Chad* case.[52]

The International Court of Justice (and its predecessor the Permanent Court of Justice) also applied the principle of effectiveness to ensure the effective operation of a treaty and its separate provisions in other case law. Examples are

Notes

44 F.P.G. Pötgens, 'Nogmaals art. 15 en 16 belastingverdrag met België: inkomsten uit tegenwoordige privaatrechtelijke dienstbetrekking', *Maandblad Belastingbeschouwingen* 4 (___): 130 and 131 and Engelen, *supra* n. 31, at 549 and 550.

45 The taxpayer (X) explicitly took this position. There was an employment relationship under Belgian law and, in his view, the Netherlands was obliged to follow this position.

46 A somewhat comparable matter is included in para. 8.10 of the Commentary to Art. 15 OECD Model Convention. Under certain circumstances, the Residence State is required to follow the Source State's interpretation of the term 'employment'. The Netherlands made no observation on this point.

47 Engelen, *supra* n. 6, at 505.

48 G. Fitzmaurice, 'The Law and Procedure of the International Court of Justice: Treaty Interpretation and Certain Other Treaty Points', *British Yearbook of International Law* 28 (1951): 19, Oxford: Oxford University Press, 1951.

49 See also H. Lauterpacht, 'Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties', *British Yearbook of International Law* 26 (1949): 48, Oxford: Oxford University Press, 1949.

50 *Third Report on the Law of Treaties* (ILC Yearbook vol. 2), p. 219, United Nations 1966.

51 See also R. Gardiner, *Treaty Interpretation* (Oxford: Oxford University Press, 2008), 160.

52 ICJ 3 Feb. 1994, Territorial Dispute (*Libyan Arab Jamahiriyaichad v. Chad*).

the judgments in the *Injuries* case[53] (although the International Court of Justice did not explicitly refer to the principle of effectiveness,[54] the nature of the legal considerations show that it was taken into account)[55] and the *Corfu* case.[56][57]

Despite the International Court of Justice's unequivocal position on the application of the principle of effectiveness, it is often argued that this principle should be more restrictively applied. The authors refer to the dissenting opinion of judge Shahabuddeen in the *Bahrain v. Qatar* case.[58] In its judgment in this case, the International Court of Justice applied a comparable interpretation to that applied in the *Libya v. Chad* case. It based this comparable interpretation on the principle of effectiveness.[59] Shahabuddeen had reservations about the application of the principle of effectiveness and feared an overly extensive interpretation that would override the text of the treaty. According to Shahabuddeen, it is not up to a judge to correct inadequacies in a treaty text. Shahabuddeen argues that his position is supported in the literature on this subject, for example, Sir Hersch Lauterpacht recognized that while a treaty aims at achieving a specific objective, a lacuna in the wording can prevent it from doing so.[60] According to Shahabuddeen, even if a specific objective can be established, this does not mean that this objective must be realized at all costs.[61]

It must, however, be emphasized that the International Court of Justice has shown itself to be aware of the risks referred to by Shahabuddeen. It argues that the principle of effectiveness does not permit an interpretation that is contrary to the letter and spirit of the relevant treaty.[62] In the case of tax treaties, the letter and spirit can be sufficiently established. The objective of a tax treaty and of Article 23 OECD Model Convention in particular is the avoidance of double taxation.

As the authors concluded in section 2.1, the wording of Article 23 OECD Model Convention allows numerous interpretations of the phrase 'in accordance with the provisions of this Convention, may be taxed in the other Contracting State', that is, both the view that the Residence State must follow the Source State's qualification and that the Residence State may interpret the treaty independently are arguable. Pursuant to International Court of Justice case law, the interpretation that is most appropriate for avoiding double taxation must be given precedence.

4. The Significance of the Principle of Effectiveness for the Dutch Observation

Given the contours of the principle of effectiveness, the question arises as to how the Dutch observation to Article 23 OECD Model Convention relates to this principle. The outcome of the Dutch observation is by definition dependent on the nature and circumstances of each individual case. However, if the Netherlands were to maintain its position as set out in the observation, double taxation that would otherwise have been avoided in a number of cases[63] by following the interpretation prescribed by the OECD Commentary, could occur.

The resultant double taxation would without question be contrary to the letter and spirit of Article 23 and the treaty. The principle of effectiveness requires that precedence be given to the interpretation that follows from the Commentary to the OECD Model Convention; as

Notes

53 ICJ 11 Apr. 1949, *Reparation for Injuries Suffered in the Service of the United Nations*.

54 The Court here faces with a new situation. The questions to whom it gives rise can only be solved by realizing that the situation is dominated by the provisions of the Charter considered in the light of the principles of international law (…) international law, the Organization must be deemed to have those powers which, though not expressly provided in the Charter, are conferred upon it by necessary implication as being essential to the performance of its duties.

55 See Fitzmaurice, *supra* n. 48, at 19.

56 ICJ 9 Apr. 1949, *Corfu Channel (United Kingdom of Great Britain and Northern Ireland v. Albania)*.

57 It would indeed be incompatible with the generally accepted rules of interpretation to admit that a provision (…) should be devoid of purport or effect. In this connexion, the Court refers to the views expressed by the Permanent Court of International Justice with regard to similar questions of interpretation. (…): 'In case of doubt, the clauses of a special agreement by which a dispute is referred to the Court must, if it does not involve doing violence to its terms, be construed in a manner enabling the clauses to have appropriate effect'.

58 Dissenting opinion 15 Feb. 1995, *Qatar v. Bahrain*, Judge Shahabuddeen.

59 Any other interpretation would encounter serious difficulties: it would deprive the phrase of its effect and could well, moreover, lead to an unreasonable result. In fact, the Court has difficulty in seeing why the 1990 Minutes, the object and purpose of which were to advance the settlement of the dispute by giving effect to the formal commitment of the Parties to refer it to the Court, would have been confined to opening up for them a possibility of joint action which (…), moreover, had proved to be ineffective.

60 Sir Hersch Lauterpacht, *The Development of International Law by the International Court* (Cambridge: Cambridge University Press, 1996), 227 (Reprint: originally London: Stevens & Sons Limited, 1958).

61 Admissibility of Hearings of Petitioners by the Committee on South West Africa case, ICJ reports, p. 58, separate opinion. Shahabuddeen concludes by referring to a consideration by Judge Lauterpacht: 'The clauses of the Peace Treaties of 1947 relating to settlement of disputes were, as shown in their wording and the protracted history of their adoption, formulated in terms which clearly revealed the absence of agreement to endow them with a full measure of effectiveness'.

62 See, e.g., ICJ 18 Jul. 1950, Interpretation of peace treaties with Bulgaria, Hungary, and Romania: The principle of interpretation often expressed in the maxim: *ut res magis valeat quam pereat*, often referred to as the rule [of] effectiveness, cannot justify the Court in attributing to the provisions for the settlement of disputes in the Peace Treaties a meaning which, as stated above, would be contrary to their letter and spirit.

63 The interpretation of the OECD Commentary does not always prevent double taxation; see also Rust, *supra* n. 4, at 45 et seq., and Vogel, *supra* n. 4, at 41 et seq.

had earlier been argued by Engelen.[64] The judgment in *BNB* 2002/153, epitomizes the consequences of the interpretation of Article 23 OECD Model Convention, which the Netherlands, according to its observation, adheres to. These consequences involve double taxation that would definitely have been avoided if the OECD Commentary had been followed.

If the principle of effectiveness leads to rejection of the Dutch observation in favour of the solution recommended in the OECD Commentary,[65] then the question arises whether that same OECD Commentary is consistent with the principle of effectiveness. The OECD Commentary only provides a solution for the avoidance of double taxation in the event of qualification conflicts. The only solution available for interpretation conflicts, in particular if a tax treaty does not contain an arbitration clause, is the often uncertain path of a mutual agreement procedure. The International Tax Group considers there to be more ground for application of the interpretation that requires the Residence State to follow the Source State's classification, thereby also avoiding double taxation in those cases where, according to the OECD Commentary, only the mutual agreement procedure can provide a solution.

5. Conclusion

In this article, the authors have discussed the distinction the OECD Commentary makes between qualification and interpretation conflicts. The authors have shown that the Commentary to Article 23 OECD Model Convention applies a rather restrictive definition of qualification conflicts where the Residence State is required to follow the Source State's qualification and thereby avoid double taxation. The authors have also shown that the Commentary to OECD Model Convention articles other than Article 23 is not always consistent in respect of the rather restrictive definition of qualification conflicts provided for in paragraphs 32.3 of the Commentary to Article 23 OECD Model Convention. The authors have shown that the International Tax Group applies a broader approach on this issue; this approach can be considered to be in line with a consistent interpretation of Article 23 OECD Model Convention. It would therefore be preferable if paragraphs 32.1–32.7 of the Commentary to Article 23 OECD Model Convention were to be brought in line with this approach.

The Netherlands has made an observation on the Commentary to Article 23 OECD Model Convention to the effect that the Netherlands will only follow the solution for qualification conflicts recommended by the OECD Commentary if this has been agreed in a specific treaty provision, is the result of a mutual agreement procedure, or is a unilateral policy judgment. The scarce Supreme Court case law (*BNB* 2002/153) on this issue appears to support this position, although several subtle distinctions need to be made with regard to this conclusion, for example the fact that paragraphs 32.1–32.7 were included in the OECD Commentary after the conclusion of the former tax treaty with Belgium on which the Supreme Court rendered a judgment in *BNB* 2002/153.

The authors then addressed the principle of effectiveness that must be followed in the interpretation of tax treaties. This principle is implicit in the general rule of interpretation of Article 31(1) Vienna Convention and has been applied in International Court of Justice case law. The consequence of the principle of effectiveness is that the Netherlands, as Residence State, must interpret the tax treaty in such a manner as to avoid double taxation. Article 23 OECD Model Convention provides a solid basis for such an interpretation. The position taken in the observation is not consistent with the above. The observation is therefore untenable and incompatible with international public law. It would therefore be advisable to drop the observation. The authors regret that the Ministry of Finance failed to make use of the opportunity to waive this observation in its 2011 tax treaty policy memorandum, but the next update of the Commentary to the OECD Model Convention will provide another opportunity to do so.[66]

Notes

64 Engelen, *supra* n. 6, at 505.

65 J. van Strien drew a similar conclusion in *Renteaftrekbeperkingen in de vennootschapsbelasting* (Fiscale Monografieën No. 119) (Deventer: Kluwer 2007), 235, albeit on different grounds (simplicity and legal certainty).

66 See also Engelen, *supra* n. 31, at 550.