CONFERENCE REPORT

Vienna University Conference 2007 Source versus Residence – The Allocation of Taxing Rights in Tax Treaty Law

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From 8 to 10 November 2007 a conference on 'Source versus Residence – The Allocation of Taxing Rights in Tax Treaty Law' was held at the Vienna University of Economics and Business Administration, to discuss problems, and possible alternatives to, the distributive rules of the OECD Model Convention (OECD MC). The conference was chaired by *Michael Lang*, *Pasquale Pistone*, *Josef Schuch* and *Claus Staringer*. Papers on each distributive rule of the OECD MC were prepared and distributed prior to the conference. For each paper, a discussant was asked to present and critically review the position taken in the paper. These input statements, together with the written contributions, served as a basis for discussion during the conference sessions. This report provides an overview of the various issues discussed during the conference and in the written contributions. It follows the structure of the conference. A book containing all contributions prepared for the conference will be published in the coming months.

Business Income (Art. 7 OECD MC)

The first session covered business income under Art. 7 OECD MC. The discussant *Michael Wichmann* presented a paper prepared by *Reuven Avi-Yonah*. In his paper on Art. 7 OECD MC, *Avi-Yonah* held that the 'Authorised OECD Approach', which treats permanent establishments as if they are legally distinct, separate enterprises and applies the arm's length principle of Art. 9 OECD MC, is inappropriate. In his opinion, the 'Authorised OECD Approach' not only fails to reflect business reality, it also imposes a costly burden on multinational enterprises. In addition, he argues that the concepts developed under Art. 9 OECD MC and the Transfer Pricing Guidelines do not work well. As a solution, he proposes to limit Art. 9 OECD MC to those situations where a business is not unitary and to design a formulary apportionment approach within the context of Art. 7 OECD MC. Under a formulary apportionment system, a multinational firm's global income would be allocated to the different tax jurisdictions according to the firm's activity in a particular country. *Avi-Yonah* believes that this would lead to simplification and help to reduce tax-distorted decisions.

Wichmann objected that formulary apportionment has also many weaknesses. In his opinion, the key problem of taxing global businesses is territorial taxation. He pointed out that the separate entity approach is a universal tax principle that fully corresponds to the territoriality principle while formulary apportionment would distort territorial taxation. Additionally, he argued that there is no solution for an appropriate formula to apply formulary apportionment. Nevertheless, *Wichmann* agreed that formulary apportionment deserves further study in specific areas, such as within the European Union.

The conflict between the 'Authorised OECD Approach' and formulary apportionment was also reflected in the discussion that followed. While some argued in favour of formulary apportionment and pointed out the problems of an arm's length approach, others tried to justify the separate entity approach and the application of the Transfer Pricing Guidelines. Several discussants agreed that efforts should be undertaken to design a formulary apportionment system within the European Union.

Immovable Property (Art. 6 OECD MC) and Shipping, Inland Waterways Transport and Air Transport (Art. 8 OECD MC)

During the second session, Art. 6 and Art. 8 OECD MC were discussed. The paper on immovable property was prepared by *Ekkehart Reimer* and presented and discussed by *Raul-Angelo Papotti*. *Guglielmo Maisto* prepared the paper on shipping, inland waterways

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transport and air transport, which was discussed by *Alexander Hemmelrath*.

In his paper, *Reimer* first analyzes the justification for situs-based taxation for immovable property. Secondly, he examines the meaning of Art. 6 (4) OECD MC and the delimitation of the scope of Art. 6 OECD MC from the scope of other articles, mainly Art. 7 and Art. 21 OECD MC. For bilateral cases, *Reimer* proposes the simultaneous application of both Art. 6 and Art. 7 OECD MC. As a result, Art. 6 OECD MC would allocate income and Art. 7 OECD MC would serve as computation rule. He then provides possible solutions for triangular cases where a permanent establishment derives income from immovable property located in a third state. *Reimer's* preferred solution would be that the permanent establishment state is obliged to grant relief from double taxation according to the non-discrimination clause for permanent establishments.

In the subsequent discussion, problems in *Reimer's* proposal for solving triangular cases were mentioned. Some discussants also argued in favour of applying Art. 21 OECD MC, rather than applying Art. 6 and Art. 7 OECD MC simultaneously for solving triangular cases. Another issue discussed was the lack of a definition for income from immovable property in the OECD MC.

In his contribution on Art. 8 OECD MC, *Maisto* first examines the reason and consistency of a specific rule for shipping and air transport and concludes that there are several good reasons for having a special rule. He then examines whether Art. 8 OECD MC should also apply to railway and road transportation and finds that there are no conceptual reasons to exclude railway and road transportation. He therefore suggests extending the regime of Art. 8 OECD MC to profits from international railway transportation. *Maisto* finally analyzes whether the criterion for exclusive taxation under Art. 8 OECD MC should be the place of effective management or residence. He pleads for a replacement of the place of effective management criterion with the residence criterion. Additionally, he suggests deleting the paragraphs in the Commentary that leave it up to the contracting states to agree on one of the criteria.

In the discussion that followed, it was held that an advantage of the place of effective management criterion is its applicability to individuals as well as to legal entities and partnerships. It was thus questioned whether using the residence criterion is a better solution. The issue was also raised whether there really is a justification for the existence of Art. 8 OECD MC. It was argued that it may be easier to have one general rule for the treatment of business profits. According to this approach, income now falling under Art. 8 OECD MC would instead be covered by Art. 7 OECD MC.

Dividends (Art. 10 OECD MC)

The paper on Art. 10 OECD MC was prepared by *Stef van Weeghel* and discussed by *Marjaana Helminen*. In his paper, *van Weeghel* compares the different tax treaty models and shows how over time the allocation of taxing rights for dividends has shifted from the source state to the residence state. The OECD MC provides for a mixed situation, i.e. both the residence and the source state may tax the dividends. *Van Weeghel* raises the question whether there is a preferable approach but takes no position on this issue. Different views were taken in the discussion.

According to one approach, dividends should be taxed exclusively in the state of residence. It was argued that residence state taxation could increase tax neutrality: Art. 11, Art. 12, and Art. 13 OECD MC should also be based on a similar system. Besides, residence state taxation could help to reduce other problems: it would no longer be necessary to make a distinction between portfolio and direct investments, and the source state would not have to deal with the question whether the withholding tax should be levied on a gross or a net basis. On the other hand, problems of feasibility due to insufficiencies in the exchange of information were acknowledged. A realistic proposal may, as a first step, be the implementation of residence state taxation for dividends within the European Union.

According to a different view, perfect tax neutrality can only be achieved if investors are treated equally. Supporters of this view believe that this is only possible based on the principle of origin, a system in which the right to tax is allocated to the state where the profit is generated. Apart from that, it was argued that a strict residence state solution would give all the taxing rights to industrialized countries at the expense of developing countries. Alternative ways to resolve the controversy were also discussed. It was proposed that the source state could impose higher corporate income tax to compensate for a loss of tax revenues as result of a definitive shift of the right to tax dividends from the source state to the residence state.

Furthermore, problems related to the definition of the term 'dividend' were posed, and it was pointed out that this question seems to become more and more relevant in a world of private equity funds and hybrid financial instruments. Some discussants addressed problems related to the 'beneficial ownership' concept. *Van Weeghel* defended his view that a 'beneficial owner' should be defined as to exclude only agents and nominees. He strongly argued in favour of more clarity in this respect.

Interest (Art. 11 OECD MC) and Royalties (Art. 12 OECD MC)

The paper on Art. 11 OECD MC was drafted by *Robert Danon* and defended by *Alexandra Storckmeijer*. The discussant was *Marco Lombardi*. *Danon* points out in his paper that the functioning of Art. 11 OECD MC may lead to double taxation in some cases. This is a consequence of the fact that the 10 per cent source tax is calculated on the gross amount of interest. Such source tax calculated on a gross basis may exceed the tax base in the residence state and thus may not be fully creditable. Furthermore, *Danon* draws attention to policy trends within the European

Union (Interest and Royalty Directive, Savings Directive) and outside the EU (the US Model or Swiss tax treaty policy) that aim at exclusive taxation by the state of residence.

Another point raised was whether Art. 10 (3) OECD MC automatically applies in cases of Art. 11 (6) OECD MC. It was noted that this conclusion might be right in thin capitalization situations. Concerning 'normal' interest cases, e.g. if the interest paid just exceeds the arm's length price, however, *Lombardi* expressed doubts. Furthermore, it was questioned whether Art. 10 (3) OECD MC may be applicable where excessive interest is paid between sister companies since they do not hold 'corporate rights' as required by Art. 10 (3) OECD MC. *Danon* argued in favour to the extent that the excessive interest payment is solely motivated by the shareholder relationship. Finally, the discussion focused on triangular cases in which Art. 11 (5) OECD MC may lead to double imposition of withholding tax – by the state of residence of the payer and by the permanent establishment state. Again, double taxation may be the consequence if the state of residence of the creditor does not or cannot provide for a full credit. In this respect, it was noted that Art. 11 (5) OECD MC is unique to Art. 11 OECD MC. No corresponding rule can be found in Art. 10 and Art. 12 OECD MC. Art. 11 (5) OECD MC may thus create inconsistency. Other discussants expressed their view that Art. 11 (5) OECD MC overrules the source tax rule and, thus, only the permanent establishment state may tax.

The second paper concerning royalties was prepared by *Niv Tadmore* and discussed by *Michael Lennard*. In his paper *Tadmore* elaborates the difficulties in identifying the source of income in relation to royalties since the underlying concept is an economic one and not a physical one. He then draws attention to the fact that return on license capital, which has to be seen as one of the components of royalties, is economically attributable to the source state. Thus, he argues that part of the income should be taxable in the source state as proposed e.g. by the UN Model. *Lennard* supported that view to the extent that source taxation should not be too high in order not to discourage investment and, as a consequence, the transfer of knowledge, technology, etc. The necessity of including Art. 12 OECD MC was questioned if it does not provide for at least limited source taxation. In the absence of a separate royalties article, Art. 7 and Art. 21 OECD MC would be applicable, leading more or less to the same result.

Following the debate on Art. 10 OECD MC, the concept of beneficial ownership was heavily debated in the context of Art. 11 and Art. 12 OECD MC. A two-step approach based on an independent international fiscal meaning of the beneficial ownership requirement was proposed: In a first step, the person to whom the state of residence fiscally attributes the income stemming from the source state must be identified. In a second step, this person must then be tested if it has control over the ultimate attribution of this income. Other positions taken were, *inter alia*, that the restriction of the beneficial ownership concept to exclude only agents or nominees or that beneficial ownership should not have a legal meaning and, therefore, should not serve as legal basis for anti-abuse. According to this view, the inclusion of the beneficial ownership requirement only emphasizes that income is to be allocated under economic criteria, which is already part of national law in many states.

Capital Gains (Art. 13 OECD MC)

The paper on Art. 13 OECD MC was prepared by *Stefano Simontacchi* and discussed by *Rick Krever*. *Krever* picked up and discussed six points from the paper prepared by *Simontacchi*. The first three points concerned the notions 'capital gain', 'gain', 'capital', and 'immovable property' used in the context of Art. 13 OECD MC and the relationship of this article to Art. 7 (7) OECD MC, which uses the terms 'income' and 'profit'. Furthermore, *Krever* devoted attention to the discussion of the treatment of deemed alienations, such as with respect to exit taxes, and the treatment of stock options and employee shares. The main focus of this session, however, was on Art. 13 (4) OECD MC – the alienation of shares of companies deriving more than 50 % of their value directly or indirectly from immovable property.

The issue was heavily debated and several discussants expressed their doubts regarding Art. 13 (4) OECD MC. It was held that Art. 13 (4) OECD MC causes inconsistencies with respect to other distributive rules, e.g. in relation to Art. 6 and Art. 10 OECD MC. While many countries apply the exemption method with respect to Art. 6 OECD MC, the OECD Commentary suggests the use of the credit method in connection with Art. 13 (4) OECD MC to avoid double non-taxation. Further points of discussion were the value test in Art. 13 (4) OECD MC and whether unrealized gains connected to the immovable property should be taken into consideration.

Finally, it was suggested that the OECD should undertake a study, as was done before the deletion of Art. 14 OECD MC, on whether the deletion of Art. 13 OECD MC would result in a different allocation of taxing rights compared to the current situation. It was argued that the result would – except for cases falling under the scope of Art. 13 (4) OECD MC – generally be the same.

Employment Income (Art. 15 OECD MC) and Students and Trainees (Art. 20 OECD MC)

The paper on Art. 15 OECD MC was prepared by *Robert Waldburger* and discussed by *Bernard Peeters*. In his paper, *Waldburger* argues that the policy considerations underlying Art. 15 OECD MC are unclear. While a link is often made between the right to tax income from employment and the deductibility of the remuneration paid to the employee, this concept is not implemented consistently. Other policy considerations may also play a role, such as the compensation for benefits provided by the work state,

the physical presence of the employee or the function of the employer as withholding agent.

Waldburger identifies a wide range of interpretation problems arising under Art. 15 OECD MC. Specific attention is drawn to the definition of the term 'employer' under Art. 15 (2) (b) OECD MC, which is regarded as the most significant unresolved interpretation issue on Art. 15 OECD MC. According to *Waldburger*, the economic employer concept, where the deduction of the remuneration borne by the employer is taken to be relevant, should be rejected. *Waldburger* argues that a civil-law approach, defining the term 'employer' on the basis of the rights and duties in relation to the employee, better fits Art. 15 (2) (b) OECD MC. This view was not shared by all discussants.

Finally, *Waldburger* proposes possible amendments to Art. 15 (2) OECD MC. The proposal to delete Art. 15 (2) (b) and (c) OECD MC while possibly shortening the time span under Art. 15 (2) (a) OECD MC was supported by some discussants. However, *Waldburger* points out that such amendments would have a significant effect on the allocation of taxing rights and thus should be considered carefully. With a view to the numerous practical problems arising from the application of Art. 15 OECD MC, *Peeters* questioned the justification for source taxation under Art. 15 OECD MC. He suggested amending Art. 15 OECD MC to provide for taxation in the state of residence only.

The paper on Art. 20 OECD MC was prepared by *Luc De Broe* and discussed by *Marek Herm*. According to *De Broe*, Art. 20 OECD MC should foster the exchange of students and business apprentices between the contracting states. Art. 20 OECD MC does not allocate taxing rights but provides for a tax exemption in the host state. Specific interpretation issues are identified with regard to the term 'business apprentice'. It was suggested that a definition of the term should be provided, either by amending the Model or the OECD Commentary. It was also held that the interaction between Art. 1 OECD MC, limiting the scope of the convention to residents of one or both of the contracting states, and Art. 20 OECD MC, which may also apply to persons who are not residents of either of the contracting states, needs to be clarified. According to some discussants, deleting Art. 20 OECD MC should be considered. The exemption provided under Art. 20 OECD MC could be granted unilaterally instead. A tax treaty does not seem to be the right place to include such a provision.

Directors' Fees (Art. 16 OECD MC) and Artistes and Sportsmen (Art. 17 OECD MC)

The paper on Art. 16 OECD MC was prepared by *Rainer Prokisch* and discussed by *Ruth Mason*. According to *Prokisch*, Art. 16 OECD MC is designed to overcome difficulties in ascertaining where services exercised by board members are performed. It also provides for symmetrical treatment regarding the taxation of directors' fees and the deduction at the company level. It was, however, questioned whether these policy considerations justify having a specific provision for directors, since problems in ascertaining where services are performed may as well arise for taxpayers outside the scope of Art. 16 OECD MC.

Art. 16 OECD MC raises considerable interpretation problems with regard to the term 'board of directors', which is understood differently in a civil law and a common law context. In the German translation of Art. 16 OECD MC, the term '*Aufsichts- und Verwaltungsrat*' is used. Since the management board is not mentioned in the German-language version, *Prokisch* concludes that members of the management board are not covered by Art. 16 OECD MC. Problems arise where a treaty is concluded in German and English, both language versions being equally authoritative. *Prokisch* suggests that under such circumstances, the language version used should depend on the residence of the company in question. *Prokisch* further considers whether the scope of Art. 16 OECD MC should be expanded to include managers and concludes that such a change is not advisable, since it would require drawing a distinction between managers and regular employees.

The paper on Art. 17 OECD MC was prepared by *Daniel Sandler* and discussed by *Dick Molenaar*. *Sandler* states that a justification for the allocation of taxing rights under Art. 17 OECD MC is generally seen in the high mobility of artists and sportsmen, putting the state of source in a better position to enforce taxation. This argument is challenged by *Sandler*: if enforcing taxation is the primary concern, it is difficult to see why Art. 17 OECD MC is limited to artists and sportsmen. After all, other taxpayers may also be able to earn a substantial amount of money in a relatively short period of time abroad. *Sandler* also criticizes the fact that Art. 17 OECD MC may lead to excessive taxation if tax is levied on a gross basis in the state of source. *Sandler* suggests amending Art. 17 OECD MC to allow for source taxation of all 'celebrities', including artists, sportsmen and other individuals able to command a large amount of money in consideration for personal services. Art. 17 OECD MC should not, however, apply to 'regular' artists and sportsmen. In order to target these 'celebrities', *Sandler* proposes using a threshold based on the gross personal service income derived in the source state. Income earned in excess of this threshold may be subject to source taxation. This proposal was supported by *Molenaar*. Some discussants expressed concern that the amendments proposed by *Sandler* might undermine the permanent establishment concept. It was also questioned whether the scope of the proposed amendments should be limited to individuals.

Pensions (Art. 18 OECD MC)

The paper on Art. 18 OECD MC was prepared by *Eric Kemmeren* and discussed by *Bertil Wiman*. It was noted that Art. 18 OECD MC plays a controversial role, despite its simplicity. According to *Kemmeren,* the residence state should not have the exclusive right

to tax pensions since such an allocation of taxing rights obstructs neutrality. Pension income consists of two parts – the deferred salary and an accretion component. Since pensions are related to employment income and this income is taxed according to the ability-to-pay principle, a residence-based system hinders the efficient allocation of labour and capital. There are several other possibilities to allocate the right to tax pensions, e.g. where the employee was registered, where the pension was received or where the employee actually performed his or her work. *Kemmeren's* paper shows that neither source state taxation nor residence state taxation can solve this problem by itself. Therefore, *Kemmeren* proposes a new origin principle-based approach. According to this approach, the pension should be taxed in the country where it emerged, i.e. where the employment took place. Some discussants countered that this would be rather difficult to administer, especially in the case of employees with income from multiple countries. *Kemmeren* argued that this should not be a real problem since exchange of information systems exist. The discussion showed that the taxation of pensions causes significant problems in an international context.

Government Employees (Art. 19 OECD MC)

The paper on Art. 10 OECD MC was prepared by *Pasquale Pistone* and discussed by *Yariv Brauner*. In his contribution, *Pistone* starts with a historical overview of the development of Art. 19 OECD MC. The basic question he raises in this respect is whether it is still justified to keep Art. 19 in the OECD MC. *Pistone* does not think so: in his opinion, the main reason for the existence of a different tax treaty provision on government services is the rules of international courtesy. Art. 19 OECD MC is not part of international customary law since the element of *opinio iuris* is lacking for a characterization as such.

In the subsequent discussion, similar arguments as in *Pistonés* paper were mentioned in favour of the abolition of Art. 19 OECD MC. Apart from reasons of simplicity and neutrality, the difficulty of drawing the borderline between public and private services in respect of the carve-out clause in Art. 19 (3) OECD MC was identified in favour of deleting Art. 19 OECD MC. Besides, the existing rule seems to be rather peculiar insofar as the notion of citizenship plays a role, which is usually not the case in other distributive rules. With respect to Art. 19 (2) OECD MC further problems could arise if a person works for both the public and the private sector: how should the pension be split in such a case? May the different taxation of pensions according to Art. 18 OECD MC and Art. 19 (2) OECD MC lead to constitutional problems on domestic level regarding the principle of equality?

On the other hand, some discussants argued against the deletion of Art. 19 OECD MC. In their opinion, civil servants would fall under Art. 15 OECD MC without Art. 19 OECD MC, which might lead to difficulties regarding the operation on a 'tax-as-you-earn' basis. In addition, most of the civil servants stay abroad just for a short period of time and usually work for public agencies financed by the sending state. Consequently, for the sending state it could be a question of simplicity and sovereignty (in the wider sense) to refer to Art. 19 OECD MC: without it, the sending state would expose itself to the imminent risk of being dependent on the tax rates of another country, i.e. the residence state. Overall, the majority of the discussants were in favour of deleting Art. 19 OECD MC.

Other Income (Art. 21 OECD MC)

The different aspects regarding Art. 21 OECD MC were analysed in a paper by *Alexander Rust*. *Frank Pötgens* was the discussant. The presentation was prefaced by the opinion of the chairman, *Richard Vann*, who considered Art. 21 OECD MC a structural issue of the Model Convention. In earlier years, Art. 21 OECD MC was placed at the beginning of the Model Convention and contributed to a clearer structure of the Convention. The discussant started his presentation with the definition of functions played by Art. 21 (1) OECD MC. Art. 21(1) OECD MC covers all income and makes the OECD Model comprehensive. *Rust's* conclusion was that in all the cases Art. 21 (1) OECD MC reserves the exclusive taxing right to the state of residence. The non-resident country must refrain from taxing the income. *Rust's* interpretation of Art. 21 (2) OECD MC criticized the schedular system proposed by *John Avery Jones*. According to *Rust*, in a schedular system, dividends, interest and royalties earned by a corporation are not included in a comprehensive domestic business income definition. As a result, these types of income do not automatically fall within Art. 7 OECD MC. If a corporation earns dividends, interest and royalties arising in the other contracting state, the starting point for the analysis is not Art. 7 OECD MC but Art. 10, Art. 11, or Art. 12 OECD MC, respectively. If the income is attributable to a permanent establishment in the other contracting state, the permanent establishment provisions of Art. 10 (4) OECD MC, Art. 11 (4) OECD MC and Art. 12 (3) OECD MC make Art. 7 OECD MC applicable for the first time. The same is true for dividends, interest and royalties earned by a corporation and arising in the residence state or in a third state. They do not fall within Art. 7 OECD MC and are not covered by Art. 10 OECD MC, Art. 11 OECD MC, Art. 12 OECD MC. This leads to the application of Art. 21 OECD MC. Some colleagues argued that Art. 21 (2) OECD MC only has a declaratory meaning and that the result in applying the tax treaty does not differ depending on whether the tax treaty contains Art. 21 (2) OECD MC. *Rust* maintained that the existence of Art. 7 (7) OECD MC and Art. 6 (4) OECD MC indicates that dividends, interest and royalties, as well as income from immovable property, are more special than business income and do not fall within the ambit of Art. 7 OECD MC even if earned by business. This view opens the way for the application of Art. 21 OECD MC.

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